Petition

No. 81-1536

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In the Supreme Court of the United States

OCTOBER TERM, 1981

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS AND MARY A. TUFTS, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Whether a person who owns property subject to mortgage indebtedness for which he assumes no personal liability (nonrecourse debt), where such indebtedness is properly includable in his tax basis of the property for depreciation and other purposes, must likewise include the full measure of the indebtedness as an "amount realized" when he disposes of the property subject to the mortgage, whatever the fair market value of the property at the time of disposition.

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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JOHN F. TUFTS AND MARY A. TUFTS, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (App. A, *infra*, 1a-21a) is reported at 70 T.C. 756. The opinion of the court of appeals (App. B, *infra*, 22a-40a) is reported at 651 F.2d 1058.

JURISDICTION

The judgment of the court of appeals was entered on July 27, 1981. The court of appeals denied the Commissioner's petition for rehearing with suggestion for rehearing en banc (App. C, *infra*, 41a-42a) on October 19, 1981. By order dated January 4, 1982, Justice White extended the time within which the

Commissioner could file a petition for a writ of certiorari to and including February 16, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 752, 1001, 1011, 1012, and 1016 of the Internal Revenue Code of 1954 (26 U.S.C.), and Section 1.1001-2(b) of the Treasury Regulations on Income Tax (26 C.F.R.), are set forth in App. D, *infra*, 43a-46a.

STATEMENT

In August 1970, respondents contributed approximately $44,000 in cash to form a partnership for the purpose of constructing an apartment complex in Duncanville, Texas. Shortly thereafter, the partnership obtained a loan in the amount of approximately $1.8 million which was used to build the complex. The loan was "nonrecourse," *i.e.*, the creditor's interest was protected solely by a security interest in the property and respondents were not personally liable on the note. Each of respondents included his proportionate share of the nonrecourse indebtedness in computing his tax basis in the property, against which he thereafter claimed depreciation and other deductions attributable to the property. During the next two years, respondents received approximately $400,000 in income tax deductions from their partnership activities that served to reduce their pro rata share of the tax basis in the property (App. A, *infra*, 3a-6a; R. 370-375, 403-407; Exhs. 7-G, 8-H, 9-I, 10-J.)[1]

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[1] "R." refers to the original record filed in the court of appeals.

As a result of adverse economic conditions in the Duncanville area, the rental income generated by the apartment complex was less than anticipated so that respondents were unable to reduce any of the principal mortgage debt. Thereafter, in August 1972, when the fair market value of the complex had declined to approximately $1.4 million, respondents sold the property and their partnership interests to Fred Bayles, an unrelated third party. Bayles agreed to pay the expenses of the sale, up to $250, and took the property subject to the still outstanding $1.8 million nonrecourse mortgage. At the time of the sale, respondents' adjusted basis in the apartment complex has been reduced from $1.85 million to approximately $1.45 million (App. A, *infra*, 4a-6a; R. 406-408; Exhs. 27-BA, 28-BB, 29-BC, 30-BD, 31-BE, 32-BF, 33-BG).

On their income tax returns for 1972, each respondent reported that he had suffered a loss on the sale of his partnership interest, measured by the difference between his adjusted tax basis and the fair market value of his interest at the time of the sale.[2] On audit, the Commissioner of Internal Revenue determined that respondents had suffered no tax loss, but were liable for taxes on approximately $400,000 in capital gain on the ground that the "amount realized" on their disposition of the apartment complex was $1.8 million, the full face amount of the nonrecourse loan to which the property was subject (App. A, *infra*, 7a-8a; App. B, *infra*, 23a-24a).

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[2] Although respondents did not claim any deduction for such loss on their returns, they alleged in the Tax Court that they had, in fact, suffered a deductible long-term capital loss upon the sale of their partnership interests (R. 226, 246, 262, 278, 293, 310; Tr. 12-13).

Respondents thereafter commenced this proceeding in the Tax Court for redetermination of the ensuing deficiencies determined by the Commissioner. The Tax Court upheld the Commissioner's determination (App. A, *infra*, 7a-21a). It ruled that because respondents properly took the total nonrecourse liability of the partnership into account in computing their basis and the tax deductions attributable to the property, the total liability also had to be included in the "amount realized" when the partnership's property was transferred subject to the encumbrance, regardless of the property's fair market value at that time. Otherwise, the court noted, the partners would be able to claim double tax deductions with respect to the same property (*id.* at 13a). In so holding, the Tax Court followed *Millar* v. *Commissioner*, 67 T.C. 656, 660 (1977), aff'd on this issue, 577 F.2d 212 (3d Cir.), cert. denied, 439 U.S. 1046 (1978), which, on virtually identical facts, rejected respondents' argument—based upon *Crane* v. *Commissioner*, 331 U.S. 1, 14 n.37 (1947)—that the nonrecourse debt is not includable in the "amount realized" where the value of the property was less than the liability. If footnote 37 of this Court's *Crane* opinion were read to provide an exception to the *Crane* rule when the value of the property is less than the liability, the Tax Court observed, "the result would be totally inconsistent with the rationale for the holding of [this Court in *Crane*] * * *, since the total liability has been taken into consideration in determining other tax consequences of the transaction, the total liability must also be included in the amount realized when the property is transferred." (App. A, *infra*, 14a).

The court of appeals reversed (App. B, *infra*, 22a-40a). Expressing "serious reservations" (*id.* at 32a) as to this Court's decision in *Crane* v. *Commissioner*, *supra*, the court of appeals held that nonrecourse debt is includable in the amount realized only to the extent of the fair market value of the property securing the debt. Despite the contrary premise of *Crane*, the court below concluded that there was "no relationship between basis, adjustments to basis, and amount realized" (App. B, *infra*, 35a n.9). It therefore held that respondents' sale of their partnership property subject to a nonrecourse debt in excess of their basis did not result in taxable gain to them. The court acknowledged, however, that its holding was "in direct conflict with decisions in other circuits" (*id.* at 34a n.9).[3]

REASONS FOR GRANTING THE PETITION

1. The decision of the court of appeals squarely conflicts with *Millar* v. *Commissioner*, 577 F.2d 212 (3d Cir.), cert. denied, 439 U.S. 1046 (1978). Under

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[3] Judge Williams concurred in the result (App. B, *infra*, 35a-40a). In his view, Section 1001(b) of the Code, which defines "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received," required a decision for respondents. Although he acknowledged that the respondents' release from the nonrecourse debt constituted property other than money, he determined that "the fair market value of the release corresponds directly to the fair market value of the property securing the nonrecourse indebtedness" (App. B, *infra*, 39a). He therefore concluded that the amount realized by respondents when they sold the property was limited to $1.4 million, its fair market value at the time. Recognizing that this result "produces grave consequences for the equitable administration of the tax code" (*id.* at 40a), Judge Williams called for a "retool[ing of] the code mechanism" for policing exaggerated depreciation and loss deduction claims grounded on a basis inflated by nonrecourse borrowing (*ibid.*).

the court of appeals' ruling, a person who borrows $1 million on a nonrecourse basis to purchase property for $1 million can claim a $100,000 tax loss on the subsequent sale of the property subject to the unamortized debt, if the value of the property declines to $900,000 during the period of his ownership. This result, which permits a person to take a tax loss in excess of his actual economic loss, bears no relationship to economic reality. The taxpayer has not disbursed a single dollar, and is not in any sense poorer than he was before the transaction. Indeed, it is the lender, not the taxpayer, who may bear the economic and tax loss attributable to the decline in value of the property in these circumstances.[4] But under the decision below, respondents are permitted to claim a tax loss equal to the lender's potential economic loss.

The court of appeals' decision in this case, therefore, has substantial administrative importance. It permits a taxpayer who has reaped large tax deductions from participation in a tax shelter investment to dispose of his interest at no tax cost when the shelter ceases to generate significant tax deductions. The net effect is an artificial tax loss bearing no relationship to the taxpayer's economic investment.

This result is contrary to this Court's teaching in *Crane* v. *Commissioner*, *supra*. There, the Court held that the face amount of nonrecourse indebtedness included in the taxpayer's basis for depreciation and other tax purposes is an "amount realized" when the property encumbered by the indebtedness is sold subject to the debt. The fact that the value of the property in this case declined below the level of the face amount of indebtedness does not, as the decision below erroneously held, render the rule of *Crane* inapplicable. As we have pointed out (*supra*, page 5), the Third Circuit has explicitly rejected that reading of *Crane* based upon the dictum in the Court's opinion (331 U.S. at 14 n.37). In *Millar* v. *Commissioner*, *supra*, the Third Circuit held, on facts virtually identical to those here, that a taxpayer's exclusion of the face amount of nonrecourse indebtedness from the amount realized on his sale of property securing the debt, where the indebtedness was included in his basis in the property, "would entitle [him] to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane*" (577 F.2d at 215). This Court should therefore resolve the conflict among the circuits with respect to its *Crane* decision in order to establish a uniform national rule.

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[4] While the lender has a potential economic loss when his security interest declines in value, he cannot claim a tax loss until he forecloses on the mortgage. Prior to foreclosure, the transaction is still open and there remains the possibility that the property might again increase in value.

2.a. Under Section 1001 of the Internal Revenue Code of 1954, gain from the disposition of property is measured by the difference between the "amount realized" from the property and the taxpayer's "adjusted basis" in the property. Generally, the amount realized is the amount received on disposition of the property. A taxpayer's adjusted basis in property, in turn, is his cost, as adjusted upward to reflect additional investments in the property, and, as adjusted downward, to reflect the depreciation, depletion and other deductions allocable to the property during the taxpayer's ownership. Internal Revenue Code of 1954, Sections 1001(b), 1011(a), 1012, 1016 (26 U.S.C.).

In the normal case, a taxpayer's cost basis in property for tax purposes is not confined to his out-of-pocket expenditures related to acquisition of the property. Rather, tax basis includes all amounts paid and all liabilities undertaken with respect to the acquired property. In turn, the amount realized upon the disposition of property generally includes debts discharged or cancelled as a result of the exchange. See, *e.g.*, *Teitelbaum* v. *Commissioner*, 346 F.2d 266, 269 (7th Cir. 1965); *Commissioner* v. *Fortee Properties, Inc.*, 211 F.2d 915, 916 (2d Cir. 1954). Thus, if A purchases property for $25,000 in cash and obtains a $75,000 mortgage loan, his basis in the property is $100,000. If he later sells it for $35,000 plus the buyer's ~~seller's~~ agreement to assume the unamortized mortgage balance of $75,000, the amount realized is $110,000 ($35,000 plus $75,000). Moreover, a taxpayer's basis does not turn on whether he is personally liable on the indebtedness encumbering the property, or whether the debt is nonrecourse in nature. In either event, the debt is includable in his cost basis and in the amount realized upon disposition. *Crane* v. *Commissioner, supra.*[5]

b. Both the Tax Court and the court of appeals purported to rest their opposite conclusions in this case upon this Court's decision in *Crane* v. *Commissioner, supra*. In *Crane*, the taxpayer's husband left her an apartment building which was subject to an outstanding nonrecourse mortgage securing a principal debt of $255,000 and interest in default of approximately $7,000. The taxpayer claimed a tax basis in the property stepped-up to the $262,000 date-of-death value (see 26 U.S.C. 1014), an amount equal to the outstanding mortgage obligation, and during the seven years she held the property, allowable depreciation deductions of approximately $28,000 were charged against that basis. Because the taxpayer during those seven years made no principal payments on the mortgage, the depreciation charges served to reduce her tax basis below the level of the outstanding mortgage debt. The taxpayer then sold the property subject to the mortgage for $2,500 in cash. On these facts, this Court held that the face amount of the mortgage was properly includable in the taxpayer's basis in the property. The Court further held that the amount realized by the taxpayer upon her subsequent sale of the property included not only the $2,500 in cash, but also the face amount of the nonrecourse mortgage to which the transferred property was subject. Thus, the taxpayer in *Crane* was taxed on approximately $23,500 of gain: the $255,000 mortgage balance plus the $2,500 cash payment (amount realized), less her adjusted basis of $234,000.

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[5] In some circumstances, the courts have held that certain excessive or ephemeral nonrecourse debts allegedly incurred in the acquisition of property are not properly includable in the purchaser's tax basis in the first instance. See, *e.g.*, *Gibson Products Co.* v. *United States*, 637 F.2d 1041 (5th Cir. 1981); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976). However, there is no contention that the nonrecourse indebtedness at issue here was of that character. Accordingly, respondents have been credited with a tax basis equal to the full face amount of the nonrecourse mortgage they obtained when their partnership acquired the property.

In reaching this result, the Court noted the "functional relation" in the Code between amount realized and basis (*Crane* v. *Commissioner*, *supra*, 331 U.S. at 12). It reasoned that as long as a nonrecourse indebtedness was includable in basis upon acquisition, it also should be included in amount realized upon disposition subject to the debt. The Court further noted that the taxpayer was in no position to urge that the amount she had realized on the disposition of the apartment building was any less than $2,500 in cash received plus the amount of the mortgage burdening the property. Otherwise, a double deduction would be available for a single loss. As the Court observed (*id.* at 15-16) (footnote omitted)):

> [The taxpayer] was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the [Revenue] Act [of 1938] itself.

The Court in *Crane* also cited the fact that the taxpayer in that case realized the face amount of the nonrecourse mortgage as an economic benefit. "If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another" (331 U.S. at 14). Because this "economic benefit" theory might not apply if the value of the mortgaged property were less than the discharged indebtedness, the Court noted parenthetically (331 U.S. at 14 n.37) that "a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot." [6]

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[6] Footnote 37 of the *Crane* opinion stated as follows (331 U.S. at 14):

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mort-

c. Here, the court of appeals declared that the principal basis of *Crane* was the economic benefit analysis employed by the Court (as well as the related observation in footnote 37) to buttress the Court's earlier conclusion that nonrecourse debt should be included in amount realized.[7] But this reasoning ignores the basic teaching of *Crane*. Since the mortgage in that case was included in the taxpayer's basis and was the foundation for all the tax deductions previously taken with respect to the property, it had to be included in amount realized to reflect the "functional relation" of the two concepts (331 U.S. at 12). The court of appeals, however, declared that "[t]here is simply no relationship between basis, adjustments to basis, and amount realized" (App. B, *infra*, 35a n.9). In so holding, the court of appeals rejected the fundamental premise on which the tax treatment of debt-financed property has been based. Since this Court's *Crane* decision, it has been settled that nonrecourse debt burdening property is includable in the owner's tax basis as long as it bears a reasonable relationship to the property's value at the time the initial basis is determined.[8] See, *e.g.*, *Mayerson* v. *Commissioner*, 47 T.C. 340, 352 (1966); cf. *Gibson Products Co.* v. *United States*, 637 F.2d 1041 (5th Cir.

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gage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

[7] The court of appeals so interpreted *Crane* even though it viewed this economic benefit theory as "seriously flawed" in any event (App. B, *infra*, 30a).

[8] Here, the parties stipulated (Tax Court Stip. ¶ 11) that the full face amount of the nonrecourse debt was properly includable in taxpayer's initial basis in the apartment complex.

1981).[9] That tax basis, in turn, forms the foundation for virtually all subsequent tax reporting with respect to the property. It is one of the keys to computing the investment credit (Internal Revenue Code of 1954, Section 48), the foundation upon which depreciation and depletion rest (Internal Revenue Code of 1954, Sections 167(g) and 612, respectively), and the starting point for computing taxable gain or deductible loss on the disposition of property. (Section 1001 (a)). To deny the "functional relation" between amount realized and basis is flatly to reject this Court's teaching in *Crane* and to have tax consequences flow from the fair market value of property—even where that value has no economic effect upon the owner of the property. See generally Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 Or. L. Rev. 3 (1980); Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. Pa. L. Rev. 69 (1969); Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 Tax L. Rev. 277 (1978). As Professor Bittker has observed (*id.* at 284):

> Whether the value of the property at * * * [the] time [of disposition] is just barely sufficient to pay off the debt, or falls short of that amount,

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[9] In *Gibson Products*, the court held that nonrecourse indebtedness exceeding the fair market value of the property securing the debt was includable in basis only to the extent of the property's fair market value. Upon ultimate disposition of the property, the maximum inclusion in "amount realized" for the nonrecourse debt to which the property was subject would, in that circumstance, be the amount originally included in the taxpayer's basis. This result maintains the "functional relation" of the two concepts.

> and what happens to its value thereafter, are matters of concern to the mortgagee and the new owner; but the old owner has no reason to worry about these matters. It has been argued above that the result in *Crane* can be justified only if the amount realized by a taxpayer who disposes of property encumbered by nonrecourse debt in excess of its basis is viewed as a balancing entry, which brings the tax results into conformity with economic reality. If this is its function, the amount realized should be computed by reference to the taxpayer's adjusted basis, the amount of the nonrecourse debt, and the cash or other property (if any) received by him. If it falls out that the property is worth less than the debt, that is the lender's misfortune; but this should no more affect the taxpayer's tax returns than it affects his economic position.

The present case is a perfect illustration of Professor Bittker's point. Respondents invested approximately $44,000 in cash in the apartment complex and financed the remainder of the project with a $1.8 million nonrecourse loan. During their ownership, they claimed approximately $400,000 in tax deductions with respect to the complex that served to reduce their original basis of $1,844,000. Thus, at the time of sale, respondents had an adjusted basis of approximately $1.4 million. To permit respondents to include only $1.4 million (instead of $1.8 million) as the amount realized effectively sanctions deductions well in excess of any monetary outlay or other actual economic loss, and destroys the symmetry between amount realized and basis which governs the taxation of sales or other dispositions of property.[10]

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[10] The court of appeals incorrectly characterized the government's position as requiring respondents to "surrender"

Respondents cannot have it both ways—including the full amount of the loan in their basis for purposes of depreciation, but excluding part of it upon the sale of the property. Indeed, apart from the decision below, an unbroken line of authority requires the inclusion of the full amount of the indebtedness upon the sale of the property. See *Millar* v. *Commissioner*, *supra*; *Woodsam Associates, Inc* v. *Commissioner*, 198 F.2d 357 (2d Cir. 1952), aff'g 16 T.C. 649 (1951); *Estate of Levine* v. *Commissioner*, 634 F.2d 12, 15 (2d Cir. 1980) (Friendly, J.); Treasury Regulations on Income Tax (1954 Code), Section 1.1001-2 (26 C.F.R.) (providing that the amount realized upon the disposition of property subject to nonrecourse indebtedness includes the full amount of the indebtedness, regardless of the value of the property securing the debt).[11] See also *Parker* v. *Delaney*, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951); *Mendham Corp.* v. *Commissioner*, 9 T.C. 320 (1947);

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previously taken deductions (see App. B, *infra*, 27a n.4). Section 1016(a)(2) requires that basis be adjusted by virtue of those deductions. The only "surrender" inherent in our position is of those "additional" depreciation deductions defined in Section 1250 of the Code which Congress directed to be recaptured upon the sale of depreciable realty. The remainder of the gain inherent in our position will be taxed as capital gain. Respondents, of course, presumably received the benefit of deductions from ordinary income when they claimed the $400,000 in deductions earlier.

[11] Section 1.1001-2 of the Treasury Regulations was promulgated on December 12, 1980, while this case was pending in the court of appeals. T.D. 7741, 1981-1 Cum. Bull. 430 (45 Fed. Reg. 81744 (1980)). The Commissioner's Regulations are entitled to great deference. See *National Muffler Dealers Association* v. *United States*, 440 U.S. 472, 488 (1979); *Crane* v. *Commissioner*, *supra*, 331 U.S. at 7.

Lutz & Schramm Co. v. *Commissioner*, 1 T.C. 682 (1943).[12]

In our view, the Third Circuit in *Millar* v. *Commissioner, supra*, properly held, on facts virtually identical to the instant case, that nonrecourse debt is includable in ~~basis,~~ amount realized regardless of the value of the property. There, the taxpayers were the owners of stock which they had acquired in exchange for certain nonrecourse notes. Thereafter, when the stock had become essentially worthless, the noteholder foreclosed upon the stock. In holding that the full face amount of the outstanding nonrecourse debt had to be included in the amount realized by the shareholders upon the foreclosure, the Court stated (577 F.2d at 215):

> While not personally liable upon the loan from Jamison, the taxpayers utilized those funds to increase the basis of their stock, which then permitted them to claim sizable deductions calculated against that basis. See 26 U.S.C. §§ 163, 1374(a), (b). Having substantially reduced the adjusted basis of their stock in this manner and thereafter surrendering their devalued stock in exchange for the cancellation of their indebted-

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[12] Section 752(c) of the Code does not, as the court below erroneously held (App. B, *infra*, 14a-19a), support its decision in favor of the taxpayer. That provision was intended to codify the rule of law established in *Crane*. Thus, the court's failure to apply the *Crane* rule correctly led it to misinterpret the thrust of that provision. As the legislative history of Section 752(c) makes clear, the fair market value limitation of the provision was intended to apply only to contributions to, and distributions from, the partnership; it was not intended to affect outright sales of partnership interests, as in the instant case. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A236 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 405 (1954).

> ness, the taxpayers clearly realized taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock. A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane.*

Nor did the court in *Millar* believe that footnote 37 in *Crane*[13] dictated the opposite result. Rather, it concluded that the footnote "should be evaluated in the proper context" (*id.* at 215). As the court stated (*id.* at 215-216):

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[13] Footnote 37 of this Court's *Crane* opinion has been described as "the most famous footnote in tax history" (Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case,* 33 Tax L. Rev. 277 (1978)). It has also been a fertile ground for legal scholarship. None of the commentators who have addressed it has, to our knowledge, advocated the result reached by the court of appeals in this case. See, *e.g.,* Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; An Imaginary Supreme Court Opinion,* 21 Tax L. Rev. 159 (1966); Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing,* 118 U. Pa. L. Rev. 69 (1969); Drye, *The Income Tax Effect of Mortgages,* 17 Wash. & Lee L. Rev. 1 (1960); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion,* 14 Tax L. Rev. 225 (1959); Johnson, *Tax Models for Nonrecourse Employee Liability,* 32 Tax L. Rev. 359 (1977); Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public,* 27 Tax L. Rev. 525 (1972); Rubin, *Tax Problems in Real Estate Mortgages Transactions,* 1960 Tul. Tax Inst. 524; Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?,* 53 S. Cal. L. Rev. 1 (1979); Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37,* 59 Or. L. Rev. 3 (1980); Spears, *Mortgages in Excess of Basis,* 1959 S. Cal. Tax Inst. 883; Townsend, *Footnote 37 of* Crane: *What is the Nature of the Income,* 4 Rev. of Tax. of Individuals 128 (1980).

> First, it must be remembered that the footnote in *Crane* was *dictum.* Furthermore, the footnote was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances. Viewed in that perspective, we believe that the rationale of the Supreme Court's principal reasoning, analysis and holding in *Crane* is more clearly the measure by which the transaction *sub judice* should be decided. Thus, applying *Crane* to the facts of the case before us, it is clear that the transaction resulted in taxable gain to the taxpayers by reason of the inclusion of the nonrecourse obligation in the calculation of basis as well as the amount realized when computing the presence or absence of gain resulting to the taxpayers from the foreclosure of the notes and surrender of the stock.

3. Finally, Congress has recognized that a transferor of property subject to nonrecourse debt should include the face amount of that debt in the amount realized upon sale. Thus, in discussing certain of the "tax shelter" measures enacted in the Tax Reform Act of 1976, 26 U.S.C. 1 *et seq.* (a revenue measure which included the "at risk" provisions of Section 465), the Joint Committee Explanation (Staff of the Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d Sess. 79 (1976), *reprinted in* 1976-3 Cum. Bull. (Vol. 2) 1, 91) notes:

> In the case of a partnership, the individual partners are generally allocated a share of the partnership's depreciation recapture in accordance with the provisions of the partnership agreement concerning the allocation of partnership

> gains. The recognition of depreciation recapture by a partner may be triggered directly by a sale of the depreciated partnership property or indirectly by a disposition of the partner's interest in the partnership itself. Also, if a lender forecloses on the debt used to finance the partnership's purchase of the equipment, this is treated as a disposition which will trigger recapture. The amount "received" in a foreclosure will include the unpaid nonrecourse debt.

In sum, if the decision below is permitted to stand, a decline in the value of property burdened by nonrecourse indebtedness will produce a tax loss to the owner even though the economic loss associated with the decline in value is borne entirely by someone else, *i.e.*, the lender, who may also be able to claim a tax loss. Such an aberrational result, contrary to both *Crane* and Congress' understanding of the tax consequences of the sale of property subject to nonrecourse debt, calls for review by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1982

Appendix

APPENDIX A

UNITED STATES TAX COURT

JOHN F. TUFTS AND MARY A. TUFTS, ET AL.,[1]
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1386-76, 1429-76, 1432-76,
1434-76—1436-76

Filed August 23, 1978

SIMPSON, *Judge*: The Commissioner determined the following deficiencies in the petitioners' Federal income taxes:

Petitioner	*TYE*	*Deficiency*
John F. Tufts and Mary A. Tufts	12/31/72	$30,398.75
Clark, Inc.	7/31/73	12,729.68
William T. Steger and Ruth C. Steger	12/31/72	30,405.00
Robert C. Austin, Sr., and Birdie L. Austin	12/31/72	6,683.49
J. C. Pelt and Jewel Pelt	12/31/72	2,707.00
James E. Stephens and Eula F. Stephens	12/31/72	3,360.89

The Commissioner also determined, in the case of John F. Tufts and Mary A. Tufts, an addition to tax under section 6651(a) of the Internal Revenue Code of 1954[2] in the amount of $8,209.25 and an addition to tax under section 6653(a) in the amount of $1,519.24, but the Commissioner has conceded that the petitioners are not liable for such additions. The issues remaining for decision are: (1) Whether the amount realized by the petitioners upon the sale of their partnership interests includes nonrecourse liabilities allegedly in excess of the fair market value of the property owned by the partnership; and (2) whether the petitioners are entitled to an allowance for attorney's fees under the Civil Rights Attorney's Fees Awards Act of 1976.

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[1] Cases of the following petitioners are consolidated herewith: Clark, Inc., docket No. 1429-76; William T. Steger and Ruth C. Steger, docket No. 1432-76; Robert C. Austin, Sr., and Birdie L. Austin, docket No. 1434-76; J. C. Pelt and Jewel Pelt, docket No. 1435-76; James E. Stephens and Eula F. Stephens, docket No. 1436-76.

[2] All statutory references are to the Internal Revenue Code of 1954, as in effect during the years at issue, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners, John F. Tufts and Mary A. Tufts (husband and wife), William T. Steger and Ruth C. Steger (husband and wife), and Robert C. Austin, Sr., and Birdie L. Austin (husband and wife), all resided in Dallas, Tex., at the time they filed their petitions in these cases. The petitioners, J. C. Pelt and Jewel Pelt (husband and wife), and James E. Stephens and Eula F. Stephens (husband and wife), all resided in Duncanville, Tex., at the time they filed their petitions in these cases. The petitioner, Clark, Inc. (Clark), is a Texas corporation whose mailing address was Duncanville, Tex., at the time it filed its petition in this case. Mr. and Mrs. Tufts filed their joint Federal income tax return for 1972 with the District Director of Internal Revenue, Dallas, Tex. Mr. and Mrs. Steger, Mr. and Mrs. Austin, Mr. and Mrs. Pelt, and Mr. and Mrs. Stephens filed joint Federal income tax returns for 1972 with the Internal Revenue Service Center, Austin, Tex. Clark filed its corporate Federal income tax return for the taxable year ending July 31, 1973,[3] with the Internal Revenue Service Center, Austin, Tex.

On August 1, 1970, Mr. Pelt and Clark[4] entered into a general partnership agreement; the newly formed partnership was known as Westwood Townhouses (the partnership). The agreement provided for allocation of partnership profits and losses in the following proportions: Mr. Pelt, 90 percent and Clark, 10 percent. Neither Mr. Pelt nor Clark made any capital contributions to the partnership at the time of its formation.

On August 7, 1970, the partnership entered into a building loan agreement with the Farm & Home Savings Association (F. & H.), under the terms of which F. & H. agreed to loan the partnership $1,851,500 for the construction of a 120-unit apartment complex in Duncanville, Tex.[5] (the complex). The complex was endorsed for mortgage insurance under section 221(d)(4) of the National Housing Act, 12 U.S.C. sec. 1715*l*(d)(4). Also on August 7, 1970, the partnership executed a note and a deed of trust in favor of F. & H. Under the terms of the note, interest alone (at a rate of 8.5 percent per annum) was payable monthly, commencing September 1, 1970, to and including April 1, 1972. Beginning May 1, 1972, installments of interest and principal in the sum of $13,573.24 were payable monthly until the entire indebtedness was paid. In any event, the balance of principal remaining unpaid, plus accrued interest, was due and payable April 1, 2012. Under the terms of the note and deed of trust, neither the partnership nor its partners assumed any personal liability for the payment of the loan.

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[3] To be consistent with the references to the other partners, we will refer to Clark's fiscal year ending July 31, 1973, as its 1972 taxable year.

[4] Clark was Mr. Pelt's wholly owned corporation.

[5] On its U.S. Partnership Return of Income (Form 1065) for 1971 and the period Jan. 1 through Aug. 28, 1972, the partnership claimed a total cost basis for the complex of $1,634,411, of which $188,333 was allocated to the land and $1,446,078 to the buildings. The disposition of the remainder of the loan proceeds is unclear.

On August 21, 1970, the partnership agreement was amended to admit Mr. Tufts, Mr. Steger, Mr. Stephens, and Mr. Austin as additional general partners. Under the terms of the amendment to the agreement, the profits and losses of the partnership were allocated as follows:

Mr. Pelt	25 percent
Clark	10 percent
Mr. Tufts	25 percent
Mr. Steger	25 percent
Mr. Stephens	7.5 percent
Mr. Austin	7.5 percent

None of the newly admitted partners made any capital contribution to the partnership at the time he was admitted as a partner. The new partners were relatives and friends of Mr. Pelt. In addition, Mr. Steger and Mr. Tufts helped the partnership to obtain financing to build the complex. Although Mr. Pelt had been a builder since 1924, he had not built any apartments previously.

Construction of the complex commenced a short time after financing was arranged. The complex was completed on or about August 21, 1971, at a cost within the projected budget.

As a result of the nonrecourse liability of the partnership, each partner's adjusted basis in his partnership interest on August 21, 1970, was as follows:

Partner	*Basis*
Mr. Pelt	$ 462,875.00
Clark	185,150.00
Mr. Tufts	462,875.00
Mr. Steger	462,875.00
Mr. Stephens	138,862.50
Mr. Austin	138,862.50
	$1,851,500.00

During the taxable year 1971, the partners made contributions of cash to the partnership in the following amounts:

Partner	*Contribution*
Mr. Pelt	$21,439
Clark	308
Mr. Tufts	2,771
Mr. Steger	2,771
Mr. Stephens	231
Mr. Austin	831

During the taxable year 1972, Mr. Pelt contributed an additional $15,861.00 to the partnership. None of the other partners made any additional contributions to the partnership.

During the taxable years 1970, 1971, and 1972,[6] the partners claimed the following amounts as ordinary losses resulting from the partnership operation, exclusive of depreciation:

Partner	*1970*	*1971*	*1972*
Mr. Pelt	$21,946	$40,409.00	$20,629.25
Clark	8,779	16,163.40	8,251.50
Mr. Tufts	21,946	40,409.00	20,629.25
Mr. Steger	21,946	40,409.00	20,629.25
Mr. Stephens	6,584	12,122.80	6,188.38
Mr. Austin	6,584	12,122.80	6,188.38

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[6] Because of the sale of the partners' interests in the partnership on Aug. 28, 1972, the partnership's taxable year closed with respect to all of the partners as of such date. Secs. 706 (c) (1) and 708 (b) (1) (B); secs. 1.706-1 (c) (1) and 1.708-1 (b) (1) (iii) (*b*), Income Tax Regs.

In addition, during the taxable years 1971 and 1972, the partners claimed as their allocable shares of depreciation the following amounts:

	1971		
Partner	*First-year depreciation*	*1971 depreciation*	*1972 depreciation*
Mr. Pelt	$96	$15,334.00	$11,578.75
Clark	38	6,133.60	4,631.50
Mr. Tufts	96	15,334.00	11,578.75
Mr. Steger	96	15,334.00	11,578.75
Mr. Stephens	29	4,600.20	3,473.62
Mr. Austin	29	4,600.20	3,473.62

As of August 28, 1972, the adjusted basis of each partner in the partnership was as follows:

Partner	*Adjusted basis*
Mr. Pelt	$390,182.00
Clark	141,461.00
Mr. Tufts	355,653.00
Mr. Steger	355,653.00
Mr. Stephens	106,095.50
Mr. Austin	106,695.50

During 1971 and 1972, major employers in the Duncanville, Tex., area laid off substantial numbers of employees. In addition, overbuilding of apartments occurred. As a result of such economic conditions, the partnership was unable to rent its apartments at the originally established rents and reduced the rents in an effort to obtain more tenants. Even at the lower rentals, the complex never achieved full occupancy; 90 out of the 120 apartments in the complex represented the highest occupancy ever achieved by the partnership. The income generated by the complex was never sufficient to enable the partnership to make payments on the principal of its mortgage debt. Thus, as of August 28, 1972, the principal balance due on the mortgage note was $1,851,500.

On August 28, 1972, each partner sold his partnership interest to Fred Bayles, an unrelated third party. On the same date, each partner also conveyed all of his right, title, and interest in property owned by the partnership to Mr. Bayles. Under the terms of the agreement of sale, Mr. Bayles agreed to pay the expenses incurred by the partners as the result of such sale, including attorney's fees and accountant's fees, up to the sum of $250. He paid no other consideration to the partners. He acquired the complex subject to the liability of $1,851,500. However, as of August 28, 1972, the fair market value of the complex did not exceed $1,400,000.

Each partner reported the sale of his partnership interest on his Federal income tax return for the year 1972, and indicated that a loss had been suffered; however, no deduction was claimed for such loss. In his petition, each partner alleged that he had realized a deductible long-term capital loss by reason of the sale of his partnership interest in an amount equal to the full amount of his cash basis, and claimed he was entitled to a refund for overpayment of taxes "in an amount to be determined by the Court."

In his notices of deficiency, the Commissioner determined that each of the partners had realized a gain on the sale of his partnership interest, computed in the table on p.762.

OPINION

Section 741 provides that the sale or exchange of an interest in a partnership shall, except to the extent section 751 applies, be treated as a sale or ex-

SALE OF WESTWOOD TOWNHOUSES

Partnership basis	*Total*	*J. C. Pelt*	*Clark*	*Robert C. Austin*	*James E. Stephens*	*John F. Tufts*	*Wilhelm T. Steger*
Increases:							
Liabilities assumed	$1,851,500	$462,875	$185,150	$138,862.50	$138,862.50	$462,875	$462,875
Contributed capital:							
1971	28,351	21,439	308	831.00	231.00	2,771	2,771
1972	15,861	15,861	—	—	—	—	—
	1,895,712	500,175	185,458	139,693.50	139,093.50	465,646	465,646
Decreases:							
1970 ordinary loss	(87,785)	(21,946)	(8,779)	(6,584.00)	(6,584.00)	(21,946)	(21,946)
1971 ordinary loss	(222,972)	(55,743)	(22,297)	(16,723.00)	(16,723.00)	(55,743)	(55,743)
1971 additional first year depreciation	(384)	(96)	(38)	(29.00)	(29.00)	(96)	(96)
1972 ordinary loss	(128,831)	(32,208)	(12,883)	(9,662.00)	(9,662.00)	(32,208)	(32,208)
Adjusted basis	1,455,740	390,182	141,461	106,695.50	106,095.50	355,653	355,653
Sales price:							
Liabilities assumed by purchaser	1,851,500	462,875	185,150	138,862.50	138,862.50	462,875	462,875
Gain on sale	395,760	72,693	43,689	32,167.00	32,767.00	107,222	107,222
Ordinary gain (sec. 1250)	47,099	11,775	4,710	3,532.00	3,532.00	11,775	11,775
Capital gain	348,661	60,918	38,979	28,635.00	29,235.00	95,447	95,447

change of a capital asset.[7] Gain or loss from the sale of a partnership interest is measured by the difference between the amount realized[8] and the adjusted basis of the partnership interest, as determined under section 705.[9] Sec. 1.741-1(a), Income Tax Regs. The issue in the case before us is the extent to which partnership nonrecourse liabilities are includable in the amount realized upon the sale or exchange of a partnership interest.[10]

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[7] Sec. 741 is applicable even though the sale of the partnership interest results in a termination of the partnership under sec. 708(b), as in the case before us. Sec. 1.741-1(b), Income Tax Regs.

[8] Sec. 1001(b) provides: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *"

[9] The original basis of a partnership interest acquired by contribution is the amount of such contribution, plus the partner's allocable share of partnership liabilities. Secs. 705(a), 722, and 752(a); secs. 1.705-1(a)(4), 1.722-1, and 1.752-1(a) and (e), Income Tax Regs. As the partnership operates, a partner's basis in his partnership interest can increase or decrease. Basis is increased by any further contributions to the partnership and by the partner's distributive share of taxable income of the partnership, and is decreased (but not below zero) by distributions by the partnership and by the partner's distributive share of losses of the partnership. Certain other items, not relevant here, also result in increases or decreases to basis. Sec. 705(a).

[10] The Commissioner does not dispute the propriety of the petitioners' inclusion of the full amount of the nonrecourse liability in the bases of their partnership interests. The petitioners did not raise any question as to whether, assuming the Court finds that the full amount of the nonrecourse liability is includable in the amount realized on the disposition of their partnership interest, the Commissioner properly determined

The petitioners' position is that nonrecourse liabilities are included in the amount realized only to the extent of the fair market value of the partnership property securing the indebtedness. The Commissioner's position is that under the decisions of this Court, the fair market value of the property is immaterial in determining the amount of gain realized by the petitioners upon the sale of their partnership interests. In the alternative, the Commissioner argues that the fair market value of the complex was at least equal to $1,851,500, the amount of the indebtedness. The petitioners presented substantial and persuasive evidence supporting their view that the fair market value of the property on August 28, 1972, did not exceed $1,400,000; whereas, the Commissioner offered no substantial evidence in support of his claim for a higher valuation. Accordingly, we have made a finding in accordance with the petitioners' evidence, and that disposes of the Commissioner's alternative argument.

In support of their position, the petitioners argue first that a proper analysis of the Supreme Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), requires a decision in their favor. In *Crane*, the taxpayer inherited from her husband property subject to a mortgage debt, in an amount equal to the fair market value of the property. Several years later, facing the threat of foreclosure, the taxpayer sold the property subject to the mortgage, receiving net cash proceeds of $2,500. 331 U.S. at 3-4. The Court held that the basis of property subject to a

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that a portion of such gain was gain to which sec. 1250(a) applies. See Sec. 751(c); sec. 1.751-1(c) (4) (ii); Income Tax Regs.; M. Ginsburg, "The Leaky Tax Shelter," 53 Taxes 719, 739-741 (1975).

mortgage includes the amount of the mortgage, although the owner of the property has assumed no liability for payment (331 U.S. at 11) and that when such property is sold subject to the mortgage, the amount realized includes the amount of the mortgage debt (331 U.S. at 13). In support of its determination that the amount realized included the amount of the mortgage, the Court stated at pages 15-16:

> She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act [Rev. Act of 1938] itself, [Fn. refs. omitted.]

In support of their interpretation of *Crane*, the petitioners point to the Court's note 37 (331 U.S. at 14) and argue that it implies that if the fair market value of the property is less than the liability, the amount realized is limited to the value of the property. Such footnote states:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

The petitioners also contend that when the value of the property is less than the liability, there is no economic benefit to the taxpayer except to the extent of the fair market value of the property. Similar arguments have been advanced by other taxpayers and have been consistently rejected by this Court. *Millar* v. *Commissioner*, 67 T.C. 656, 660 (1977), affd. on this issue 577 F.2d 212 (3d Cir. 1978); *Woodsam Associates, Inc.* v. *Commissioner*, 16 T.C. 649, 654-655 (1951), affd. 198 F.2d 357 (2d Cir. 1952); see also *Mendham Corp.* v. *Commissioner*, 9 T.C. 320, 324 (1947); *Lutz & Schramm Co.* v. *Commissioner*, 1 T.C. 682, 688-689 (1943).

In *Millar* v. *Commissioner*, *supra*, the taxpayers, shareholders in a corporation known as Grant County Coal Corp. (Grant County), borrowed $500,000 from a third party. The shareholders were not personally liable for the debt; rather, the loans were secured solely by the shareholders' Grant County stock. The borrowed funds were contributed to the capital of Grant County by the shareholders. Grant County had filed an election to be treated as an electing small business corporation under subchapter S (sec. 1371 et seq.) of the Internal Revenue Code. It suffered net operating losses which, as a result of its subchapter S election, were passed through to its shareholders in proportion to their interests in the corporation; the shareholders claimed such losses as deductions on their individual Federal income tax returns. Subsequently, the lender demanded repayment of the loans; when payment was not forthcoming, he foreclosed on the taxpayers' Grant County stock. At the time of the foreclosure, the value of the stock was less than the amount of the nonrecourse loans. 67 T.C. at 657-659. The taxpayers, relying upon note 37 of *Crane*, argued that no gain had been realized. The Court rejected such argument, and held that the taxpayers had a gain to the extent that the amount realized, in that case the amount of the nonrecourse loans exceeded the adjusted basis of the surrendered stock. The Court found the fact that the value of the stock surrendered was less than the amount of the loans to be immaterial. 67 T.C. at 660. The Court pointed out that under section 1374(c)(2), the losses deductible by the taxpayers were limited to the adjusted basis of their stock in the corporation and stated with respect to the loans:

> Except for the contributions to capital obtained in this manner, petitioners would not have been entitled to deduct the losses of the corporation in the first instance. * * *
>
> * * * petitioners were entitled to include as a part of their adjusted basis within the meaning of section 1374(c)(2) the respective contributions to the capital of the corporation made out of "borrowed" funds. To the extent of such contributions, the petitioners received the benefit of deducting the losses sustained by the corporation. [67 T.C. at 659-660.]

The Court of Appeals for the Third Circuit, in affirming our decision, found it to be "totally in keeping with the spirit and reasoning of *Crane*." 577 F.2d at 215. The court held that the principal reason for the *Crane* holding was to prevent the double tax deductions which would otherwise result.[11] 577

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[11] Several commentators agree. E.g., D. Adams, "Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion," 21 Tax L. Rev. 159, 168-171 (1966); L. Del Cotto, "Basis and Amount Realized Under *Crane:* A Current View of Some Tax Effects in Mortgage Financing," 118 U. Pa. L. Rev. 69, 83-86 (1969); M. Ginsburg, "The Leaky Tax Shelter," 53 Taxes 719, 730-731 (1975).

F.2d at 215. The court further found that note 37 of the *Crane* opinion was not intended to create an exception to the rule in cases in which the fair market value of the property surrendered or exchanged is less than the amount of the nonrecourse liability to which the property is subject. 577 F.2d at 215. The footnote merely pointed out that the Supreme Court did not have before it a situation in which the value of the property was less than the liability and that the economic consequences might be different in such a situation. If note 37 were read to provide an exception when the value of the property is less than the liability, the result would be totally inconsistent with the rationale for the holding of the Court, that is, since the total liability has been taken into consideration in determining other tax consequences of the transaction, the total liability must also be included in the amount realized when the property is transferred. 577 F.2d at 215.

In the alternative, the petitioners argue that since they sold interests in a partnership, section 752(c) compels a decision in their favor. In its entirety, section 752 provides:

> (a) INCREASE IN PARTNER'S LIABILITIES.—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.
>
> (b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual

> liabilities, shall be considered as a distribution of money to the partner by the partnership.
>
> (c) LIABILITY TO WHICH PROPERTY IS SUBJECT.—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.
>
> (d) SALE OR EXCHANGE OF AN INTEREST.—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

The petitioners focus upon the language, "For purposes of this section," in subsection (c) and argue that the fair market value limitation of subsection (c) is applicable to a sale of a partnership interest under subsection (d). Thus, they contend, the amount realized upon the sale of a partnership interest includes a partnership nonrecourse liability only to the extent of the fair market value of the partnership property which is subject to the liability.

The Commissioner contends that the provisions of subsection (c), including the fair market value limitation, were intended to be applied only in connection with the rules of subsections (a) and (b), relating to contributions to and distributions from the partnership or amounts treated as such contributions or distributions. He asserts that subsection (d) operates independently of subsection (c). After a careful consideration of the parties' arguments, we agree with the Commissioner.

Section 752, enacted as part of the Internal Revenue Code of 1954, generally has been regarded as a codification of the *Crane* doctrine for the purpose of determining the basis of a partner's interest in a partnership. A. Perry, "Limited Partnerships and Tax Shelters: The *Crane* Rule Goes Public," 27 Tax L. Rev. 525, 542 (1972). Subsection (a) provides generally that any increase in a partner's share of the liabilities of the partnership will be treated as a contribution of money by the partner to the partnership, thus increasing (under secs. 705 and 722) his basis for his partnership interest. Under subsection (b), any decrease in a partner's share of the liabilities of the partnership is treated as a distribution of money by the partnership to the partner. Such a distribution reduces the partner's basis for his partnership interest, and if the distribution exceeds the adjusted basis, the excess will be recognized as gain. Secs. 705, 731, and 733. Subsection (c) adopts the *Crane* rule as to nonrecourse liabilities, providing that a liability to which property is subject shall, to the extent of the fair market value of the property, be treated as a liability of the owner of the property, and there may be reason for applying the fair market value limitation in determining the basis of a partner in the partnership (see 1 W. McKee, W. Nelson, and R. Whitmire, Federal Taxation of Partnerships and Partners, par. 7.04, pp. 7-14—7-15 (1977)).

The legislative history of section 752 suggests that the fair market value limitation of subsection (c) was intended to have narrow applicability. The committee reports state with respect to section 752:

> Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of emcumbered property

> by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities. * * *
>
> * * * * *
>
> The transfer of property subject to a liabiilty by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property. [H. Rept. 1337, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. A236 (1954); S. Rept. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. 405 (1954).]

These statements reveal that in setting forth the fair market value limitation, Congress had in mind only two situations in which it would be applicable: upon the contribution of encumbered property by a partner to the partnership, and upon the distribution of encumbered property by the partnership to a partner.

In contrast, the committee reports state with respect to the sale or exchange of a partnership interest: "When a partnership interest is sold or exchanged, *the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied.*" H. Rept. 1337, *supra* at A236-A237 (emphasis supplied); S. Rept. 1622, *supra*. The fair market value limitation is not mentioned.

The regulations also suport the view that subsection (c) has a limited effect. Section 1.752-1(c), Income Tax Regs. provides:

> (c) *Liability to which property is subject.* Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee. * * *

The regulations, issued contemporaneously with the enactment of the statute, are entitled to great weight. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496 (1948); *Fawcus Machine Co.* v. *United States*, 282 U.S. 375 (1931).

Though the language of section 752(c) is broad enough to support the petitioners' interpretation, the result of adopting such interpretation would be inconsistent with the language of section 752(d) and the rationale for the holding of *Crane.* Subsection (d) expressly provides that "In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated *in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.*" (Emphasis supplied.) The general law is well settled that when there is a sale or exchange of property subject to a liability, the amount realized includes the full amount of the liabilities, even though the liability exceeds the value of the property. *Millar* v. *Commissioner, supra; Woodsam Associates, Inc.* v. *Commissioner, supra;* see also *Mendham Corp.* v. *Commissioner, supra; Lutz & Schramm Co.* v. *Commissioner, supra.* Moreover, under the petitioners' reading of the statute, they are permitted to include in the bases of their partnership interests the full amount of nonrecourse liabilities, with the result that they are entitled to deduct the partnership losses. However, if they were permitted to exclude a portion of such liabilities from the amount realized on the disposition of their partnership interests, they could avoid accounting for such deductions upon the disposition of their partnership interest, a result *Crane* sought to prohibit.

The statute of course represents the most authoritative expression of congressional purpose, and neither the legislative history nor the regulations may be used in derogation of an unambiguous statutory expression of legislative purpose. However, the interplay of subsections (c) and (d) is not so clearly delineated on the face of the statute as to preclude reliance upon the legislative history and the regulations to ascertain and carry out the legislative purpose. See *United States* v. *Gilmore*, 372 U.S. 39, 44-45 (1963); *Doing* v. *Commissioner*, 58 T.C. 115, 129 (1972); *Southern California Loan Assn.* v. *Commissioner*, 4 B.T.A. 223, 233-234 (1926). If we accept the petitioners' interpretation of the statute, Congress has, in codifying the *Crane* doctrine, legislated the very result *Crane* sought to prohibit. A more reasonable interpretation of subsection (c) is that suggested by the legislative history and the regulations. We conclude that Congress intended the fair market value limitation of subsection (c) to apply only with respect to the contribution or distribution of encumbered property, or with respect to amounts treated as such contributions or distributions, and that subsection (d) was intended to operate independently of the fair market value limitation of subsection (c).[12]

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[12] Several commentators also have suggested this result. Moreover, the commentators point out that if we accept the

The situation in the case before us is similar to that in *Millar* v. *Commissioner, supra.* The nonrecourse liability was included in the petitioners' bases, permitting them to deduct, under section 704(d), their distributive shares of partnership losses. Had the petitioners not been able to include such amounts in their bases, their losses would have been limited to their capital contributions, which were minimal. It follows that the petitioners must, upon the disposition of their partnership interests, include in the amount realized the full amount of the nonrecourse liability.[13]

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broad interpretation of sec. 752(c) urged by the petitioners, other problems of interpretation arise. For example, if the fair market value of property subject to an encumbrance declines so that it is less than the amount of the encumbrance, will the excess of the encumbrance over the fair market value be considered a decrease in the partners' shares of partnership liabilities and treated as a distribution of money under sec. 752(b)? And if the property thereafter should increase in value, so that its value exceeds the amount of the encumbrance, is there a contribution under sec. 752(a)? 1 W. McKee, W. Nelson, and R. Whitmire, Federal Taxation of Partnerships and Partners, par. 7.04, pp. 7-12—7-13 (1977); 1 A. Willis, Partnership Taxation, sec. 22.09, pp. 262-263 (2d ed. 1976); A. Aronsohn, "The Financially Troubled Partnership," 34th Ann. N.Y.U. Inst. Fed. Tax. 327, 349-351 (1976); M. Ginsburg, "The Leaky Tax Shelter," 53 Taxes 719, 731 (1975). For a different view, see J. McGuire, "Negative Capital Accounts and the Failing Tax Shelter," 3 J. Real Est. Tax. 439 (1976).

[13] We do not pass upon whether nonrecourse liabilities in excess of the fair market value of the property securing such liabilities are included in the basis of a partnership interest acquired by purchase. Compare *Bolger* v. *Commissioner*, 59 T.C. 760, 769-771 (1973); *Mayerson* v. *Commissioner*, 47 T.C. 340, 351-354 (1966); *Blackstone Theatre Co.* v. *Commissioner*, 12 T.C. 801, 804 (1949), with *Morris* v. *Commissioner*, 59 T.C. 21, 33-34 (1972); see 1 W. McKee, *supra* at 7-14—7-15.

We must also decide whether the petitioners are entitled, under the provisions of the Civil Rights Attorney's Fees Awards Act of 1976, Pub. L. 94-559, 90 Stat. 2641, amending 42 U.S.C. sec. 1988, to an award of attorney's fees. Such Act authorizes an award of attorney's fees only to a prevailing party (other than the United States). The petitioners point out, however, that an addition to tax for negligence was determined against Mr. and Mrs. Tufts, and later was conceded by the Commissioner. They assert that at least as to Mr. and Mr. Tufts we should make an allowance for attorney's fees.

This Court has no authority to award attorney's fees unless specifically authorized to do so by act of Congress. See *Alyeska Pipeline Service Co.* v. *Wilderness Society*, 421 U.S. 240 (1975). We have held that we are not authorized by the provisions of the Civil Rights Attorney's Fees Awards Act of 1976, or any other law, to award attorney's fees to a petitioner. *Key Buick Co.* v. *Commissioner*, 68 T.C. 178 (1977), on appeal (5th Cir., Aug. 15, 1977). As we are without authority to award attorney's fees in any case, we need not consider whether Mr. and Mrs. Tufts' case would be an appropriate case for such an award, or whether the amount claimed is reasonable.

Decisions will be entered under Rule 155.

APPENDIX B

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT
UNIT A

No. 79-2258

JOHN F. TUFTS and MARY A. TUFTS, ET AL.,
PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

July 27, 1981

Appeal from the Tax Court of the United States

Before BROWN, THORNBERRY and WILLIAMS, Circuit Judges.

THORNBERRY, Circuit Judge:

In August 1970, John Tufts and the remaining appellants formed a general partnership for the purpose of constructing an apartment complex in Duncanville, Texas. The partnership arranged for a loan of approximately $1.8 million in order to finance construction of the complex. The mortgage note covered the entire cost and provided that neither the partnership nor the partners were personally liable for its repayment. The complex was completed in August 1971. Due to adverse economic conditions in the Duncanville area, the income generated by the complex was never enough to enable the partnership to make payments on the mortgage principal. As of August 28, 1972, the fair market value of the property had declined to \$1.4 million, and the principal balance due on the mortgage note remained at \$1.8 million. On that date, each partner sold his partnership interest and all of his right, title, and interest in property owned by the partnership to Fred Bayles, an unrelated third party.[1] Mr. Bayles agreed to pay the expenses incurred by the partners as a result of the sale, up to \$250. He paid no other consideration, and acquired the complex subject to the nonrecourse liability.

Each partner had included his proportionate share of the entire \$1.8 million in computing his basis in the partnership, and the Commissioner did not dispute the propriety of that computation. The Commissioner, however, included the full amount of the partnership nonrecourse liability in the amount realized upon the sale and therefore determined that each of the partners had realized a gain on the sale of his partnership interest.[2] The partners appealed

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[1] I.R.C. § 741 provides that gain or loss from the sale or exchange of an interest in a partnership shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in I.R.C. § 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

[2] I.R.C. § 1001 provides in part:

> (a) COMPUTATION OF GAIN OR LOSS.—The *gain* from the sale or other disposition of property shall be the excess of the *amount realized* therefrom over the *adjusted basis* provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided

to the tax court, arguing that nonrecourse liabilities should be included in amount realized only to the extent of the fair market value of the partnership property securing the indebtedness. The tax court upheld the Commissioner, and the taxpayers filed this appeal.

The Supreme Court held in *Crane* v. *Commissioner*, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), that when property subject to a mortgage on which the owner of the property assumes no personal liability is sold, the amount realized includes the amount of the unassumed mortgage.[3] In footnote 37 of the *Crane* opinion, however, the Court observed:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a

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in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The *amount realized* from the sale or other disposition of property shall be *the sum of any money received plus the fair market value of the property* (*other than money*) *received.* (emphasis added).

[3] Mrs. Crane inherited an apartment building worth $250,000, subject to a nonrecourse mortgage in the same amount, held it for seven years, and sold it, subject to the unamortized mortgage, for $2500 in cash. She reported a gain of $2500 on the sale, arguing that the property she had acquired from her husband's estate was only the equity in the building (which under I.R.C. § 1014 entitled her to a basis of zero), and that the amount realized for the equity when she sold it was $2500. The Supreme Court rejected her argument, holding that the property inherited by Mrs. Crane was not merely the equity, but the real estate (which under § 1014 had an unadjusted basis of $250,000), and that the amount realized on the sale also included the full amount of the nonrecourse debt.

> benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

331 U.S. at 14 n.37, 67 S.Ct. at 1054. The question presented by this appeal is whether footnote 37 creates an exception to the *Crane* holding through its clear implication that the amount realized on the disposition of property encumbered by a nonrecourse mortgage cannot exceed the fair market value of the property. Our analysis of the reasons underlying the *Crane* decision leads us to the conclusion that such a fair market value limitation is warranted. We therefore reverse the judgment of the tax court.

The Commissioner relies primarily on the decision in *Millar V. Commissioner*, 577 F.2d 212 (3rd Cir.), *cert. denied*, 439 U.S. 1046, 99 S.Ct. 721, 58 L.Ed.2d 704 (1978). The *Millar* court rejected a literal reading of footnote 37 in view of what it thought to be the principal reason underlying the *Crane* decision. The court focused on the following language:

> The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets.

557 F.2d at 215, *quoting Crane*, 331 U.S. at 15-16, 67 S.Ct. at 1055. According to the *Millar* panel, the Supreme Court was primarily concerned that the taxpayer might enjoy some sort of double deduction. The tax court below, as well as the Commissioner on appeal, agreeing with *Millar*, also identified this con-

cern for double deductions as the principal reason for the *Crane* holding. They invoke the *Crane* double deduction language in support of a tax benefit theory: the argument, in essence, is that a taxpayer who has previously enjoyed the benefit of large tax deductions, without placing his own assets at risk, has, by taking those deductions, improved his economic position, thus realizing gain. According to the Commissioner and the tax court, the taxpayer, on disposing of the property, must somehow be made to account for the benefits previously enjoyed.

We do not agree that this concern for double deductions was the principal reason underlying the *Crane* decision. The *Crane* language leaves no doubt that the Court thought that Mrs. Crane had improved her financial condition by availing herself of the allowable deductions. But before the Court had even mentioned double deductions, it had already concluded that the Commissioner had properly determined the amount realized. *After* reaching that conclusion, the Court acknowledged the distinction between statutory income (that which Congress has decided to reach through legislation) and constitutional income (that which Congress has the power to reach, if it chooses to do so). Mrs. Crane had argued in the alternative that she had been taxed on what was not income within the meaning of the sixteenth amendment. The Court responded to this constitutional argument in the last paragraph of its opinion, and in that last paragraph the Court for the first time expressed concern for double deductions. We therefore prefer to read this expression of concern as primarily a response to Mrs. Crane's constitutional argument, and not as the principal justification for the statutory holding that the Court had announced earlier in the opinion.[4]

There is an even more compelling reason why the fact that a taxpayer has previously enjoyed the benefit of large depreciation deductions is insufficient to justify an expansion of the definition of amount realized. We see, by looking to the Internal Revenue Code, that Congress has already in fact accounted for those previous deductions. According to the Code, "gain" from the sale or other disposition of property is computed by subtracting the "adjusted basis" from the "amount realized." I.R.C. § 1001(a). The "adjusted basis" is the cost of the property adjusted to reflect the depreciation, depletion, and other costs chargeable against the property. I.R.C. § 1016. Thus, any tax benefits that the taxpayer may have received in the form of prior deductions have already been factored into the gain equation through adjustments to basis. Since those deductions have been accounted for through adjustments to basis, it follows logically that they cannot also support an expansion of the definition of amount realized. To account for those deductions twice in the same equation by expanding the definition of amount realized as well as adjusting basis downward would, we think, be taxing the taxpayer twice on the same component of gain.[5] The Commissioner's reliance on a theory of tax benefit, then, is misplaced. The Code clearly provides for a "recapture" of the prior deductions,[6] but not through its definition of amount realized.

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[4] We must confess that our preference stems in part from our uncertainty as to the exact nature of the "double deductions" that concerned the Court. The Court apparently was endorsing the reasoning of Judge Learned Hand, the author of the opinion in the Court of Appeals, who stated:

> By hypothesis [the taxpayer] will have been allowed deductions seriatim, based upon the actual value of the buildings; and he will in addition have got a reduction in his gain to the extent to which actual "wear and tear" has reduced the selling price. Manifest justice demands that he must surrender one or the other. . . .

Commissioner v. *Crane*, 153 F.2d 504, 505 (2nd Cir. 1945). We had always supposed that Congress chose to allow depreciation deductions on the assumption that wear and tear would diminish the value of the property. In other words, Congress decided to compensate a property owner, by allowing him to take depreciation deductions, for an expected loss in value due to deterioration of the property. We therefore do not understand why, if the property does in fact decline in value as was expected, "manifest justice" requires the taxpayer to somehow "surrender" the previous deductions or the gain that he never realized.

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[5] We note that our analysis is entirely consistent with the *Crane* language. We fully agree that the law does not permit a taxpayer "to exclude allowable deductions from consideration in computing gain." 331 U.S. at 15-16; 67 S.Ct. at 1055. We have merely concluded that Congress chose to "consider" and account for those allowable deductions through adjustments to basis, and not though an expansive definition of amount realized.

[6] In fact, the Code does even more than merely recapture prior depreciation deductions actually taken by the taxpayer. Section 1016 requires that the basis of property be reduced by the amount of depreciation allowable whether or not it is taken. *Virginia Hotel Corp.* v. *Helvering*, 319 U.S. 523, 63 S.Ct. 1260, 87 L.Ed. 1561 (1943). Section 1016 thus operates whether or not the taxpayer has enjoyed a tax benefit via a deduction. In contrast, the tax benefit rule is designed only to prevent the taxpayer from making actual personal gains through unwarranted deductions. *See, e.g.*, I.R.C. § 111 (bad debts, prior taxes, or delinquency amounts written off in prior years must be included in income when recovered, unless the prior deductions did not reduce the tax).

When we look to what the Court said immediately before it announced its conclusion that the Commissioner had properly determined the amount realized, we see that the Court justified its result on a theory of economic benefit, first recognizing that the term "amount realized" could be expanded where an economic benefit equivalent to cash could be identified. The Court began by noting that if Mrs. Crane had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would clearly have been considered a part of the amount realized because Mrs. Crane would have received the benefit of the payment "in 'as real and substantial [a sense]' " as if the money had been paid to her and then paid over by her to her creditors. 331 U.S. at 13, 67 S.Ct. at 1054, *citing United States* v. *Hendler*, 303 U.S. 564, 58 S.Ct. 655, 82 L.Ed. 1018 (1938). That proposition and the economic principle from which it derives are indisputable: when a debt on which a taxpayer is personally liable is discharged, the taxpayer is freed from the necessity of paying the obligation with cash or other assets equal in value to the principal amount of the debt. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131 (1931). What the Court thought followed from that proposition, however, is worth quoting:

> [W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.[37] If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to

> sale, or whether he is merely to tranfer subject to the mortgage—it may make a difference to the purchaser and the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with *the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.*[38] If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

331 U.S. at 14, 67 S.Ct. at 1054-55 (emphasis addded).

This economic benefit theory is, we think, seriously flawed, in that it is premised on the notion that "an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." We admit that we initially succumbed to the facial appeal of that notion, but on reflection we are convinced that it rings true only so long as the taxpayer actually wants to keep the property.[7] If the taxpayer decides, for

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[7] Professor Bittker provides an analogy:

> The Court was, of course, right in asserting that the owner of mortgaged property must keep up the payments if he wants to retain the property and that *for this period*

any reason whatsoever, that he no longer wants the burdens and responsibilities that accompany ownership, he can transfer the property to a third party with absolutely no regard to that party's willingness or ability to meet the mortgage obligations, yet rest assured that his other assets cannot be reached. We agree with Professor Bittker:

> *of time*, he must treat the debt as a personal obligation whether he is personally liable or not. It does not follow, however, that the benefit to him from transferring the property subject to the mortgage is the same in both cases. If you crave gourmet meals, you must pay for them so long as your addiction continued; but once you break the habit, you need pay only for those you bought on credit in the past, not for those that you will skip in the future. So it is with mortgages. Nonrecourse obligations can be disregarded as soon as the property is sold, given away, or abandoned; personal liability persists even after the property has been disposed of, whether the new owner assumes or takes subject to the debt.
>
> Thus, *Crane* overstates the resemblance between nonrecourse and personal obligations.

Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277, 281 (1978). Professor Bittker rejects the economic benefit theory as "wholly fallacious," but justifies the result reached by the Court on what he calls a balancing entry theory. The *Crane* decision, according to Bittker, "was justifiable because it brought the tax consequences of the taxpayer's dealings with her property into harmony with economic reality by recapturing her depreciation deductions to the extent that they exceeded her investment in the encumbered property." *Id.* at 282. Professor Bittker, then, agrees with the Commissioner that it is somehow unfair for a taxpayer to enjoy the benefit of substantial deductions without having placed his own assets at risk. As we will note, we think that argument is properly directed at the Congress, not at the courts. It may be that Professor Bittker was so directing it. *See id.* at 284.

> Relief from a nonrecourse debt is not an economic benefit if it can be obtained only by giving up the mortgaged property. It is analogous to the relief one obtains from local real property taxes by disposing of the property. Like nonrecourse debt, the taxes must be paid to retain the property; but no one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of the taxes that will not be paid in the future.

Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 Tax L.Rev. 277, 282 (1978). We do not deny that Mrs. Crane received *some* benefit: a purchaser had to pay off the mortgage or at least be willing to take the property subject to the mortgage before Mrs. Crane could pocket her $2500 in equity. We do, however, seriously question whether the full amount of nonrecourse debt is an accurate measure of that benefit.

Because, as indicated above, we have serious reservations about the *Crane* decision, we decline to extend it beyond the facts of that case, and we therefore conclude that the fair market value limitation so "[o]bviously" anticipated by footnote 37 is warranted. We hold that the fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property.[8]

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[8] The appellants argued in the alternative that I.R.C. § 752 (c) expressly limits the amount realized from the transfer of their partnership interests to the fair market value of the property securing the nonrecourse debt. Section 752 provides in full as follows:

> § 752. Treatment of certain liabilities
>
> (a) Increase in partner's liabilities.—Any increase in a partner's share of the liabilities of a partnership,

> or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.
>
> (b) Decrease in partner's liabilities.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.
>
> (c) Liability to which property is subject.—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.
>
> (d) Sale or exchange of an interest.—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

Notwithstanding the unambiguous language of § 752(c), the Commissioner contended that Congress intended the fair market value limitation of that subsection to apply only when encumbered property was contributed to or distributed from a partnership, and that § 752(d) somehow operates independently of § 752(c). Because § 752(c) provides for a fair market value limitation, it necessarily conflicts, according to the Commissioner, with § 752(d), which provides that liabilities associated with the sale or exchange of partnership interests are to be treated in the same manner as liabilities associated with the sale or exchange of other property. Obviously, our holding extinguishes any conflict that the Commissioner might see in the provisions of § 752. Further, since § 752(c) is generally regarded to be an intended codification of the *Crane* doctrine, *see, e.g.*, Perry *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 Tax L.Rev. 525, 542 (1972), it seems that our holding is consistent with congressional understanding of the *Crane* case.

REVERSED.[9]

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[9] Because our holding is in direct conflict with decisions in other circuits, we think the following remarks are necessary to put this case in its proper perspective. First, and most important, the precise issue before this court is extremely narrow: whether the tax court properly included the full amount of nonrecourse debt in amount realized. Congress specifically defined amount realized to be the sum of any money received plus the fair market value of the property (other than money) received I.R.C. § 1001(b). The Supreme Court has held that the definition can be expanded where an economic benefit equivalent to cash can be identified. Significantly, whether the taxpayers properly included the full amount of the nonrecourse debt in the bases of their partnership interests is not an issue in this case.

We detect in the case law and the literature a legitimate concern for potential abuses or at least misuses of the tax law through various tax shelters schemes. Judge Friendly recently stated:

> If non-recourse mortgages contribute to the basis of property, then they must be included in the amount realized on its sale. Any other course would render the concept of basis nonsensical by permitting sellers of mortgaged property to register large tax losses stemming from an *inflated basis* and a diminished realization of gain. It would also permit *depreciation deductions in excess of a property holder's real investment* which could never subsequently be recaptured.

Estate of Levine v. *Commissioner*, 634 F.2d 12 (2nd Cir. 1980). *See also* Bittker, *supra* note 7, at 284-84. Judge Friendly has identified, we think, the two primary concerns that could prompt a decision like *Millar*. The first is that taxpayers will be able to use nonrecourse financing to inflate their bases in order to enjoy the benefits of large tax deductions that bears no relationship to actual economic loss. The second appears to be nothing more than a concern for fairness. The argument, we suppose, is that it is somehow unfair for a taxpayer to enjoy the benefit of substantial deductions without having invested his own funds or placed his own assets at risk.

We agree that there exists a potential for abuse. But Judge Friendly also correctly identified the reason that potential

JERRE S. WILLIAMS, Circuit Judge, concurring:

I concur with the result reached by our panel because the Commissioner's position is inconsistent with the plain language of I.R.C. § 1001(b) and I.R.C.

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exists: "non-recourse mortgages contribute to the basis of property." The real crux of the problem, then, is the taxpayer's ability to manipulate his basis and adjusted basis through the use of nonrecourse financing. The solution, in our opinion, is to deal directly with the definitions of "basis" and "adjusted basis," either judicially or through legislation. *See, e.g., Gibson Products Co.* v. *United States*, 460 F.Supp. 1109 (N.D. Tex. 1978) (nonrecourse indebtedness in excess of fair market value of the property securing the debt cannot be included in basis), *affimed*, 637 F.2d 1041 (5th Cir. 1981); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976). It is not a solution to distort the definition of amount realized by finding an economic benefit equivalent to cash where none exists. There is simply no relationship between basis, adjustments to basis, and amount realized, except where Congress has specifically legislated for recapture. In response to the notion that it is unfair for a taxpayer to enjoy the benefit of substantial deductions on property acquired with nonrecourse funds, we need only state that Congress knows how to limit deductions to amounts that the taxpayer actually places at risk, *see, e.g.*, I.R.C. § 465, and has not yet done so under the circumstances of this case.

Finally, we must respond to Judge Williams' thoughtful concurring opinion. We do not think that the fair market value limitation in I.R.C. § 1001(b) applies to this case. Judge Williams characterizes the release of nonrecourse indebtedness as "property (other than money) received" within the meaning of that section. *Crane* expanded the definition of amount realized to include economic benefits equivalent to cash. In our view, intangible cash equivalents are more akin to "money" than to "property." But even if Judge Williams is correct in this regard, we are troubled by his application of the freeing-of-assets theory. That theory makes perfect sense in the case of recourse indebtedness: when recourse indebtedness is assumed or extinguished, other assets are "freed" in

§ 752(c). I part company with the majority opinion because it rests on a differerence of opinion with the Service over the construction of § 1001 in light of the *Crane* doctrine. I doubt that we have authority to strike down the Commissioner's interpretation on the basis of "serious reservations about the *Crane* decision." We are authorized, however, to invalidate administrative regulations that conflict with the statute on which they purport to be based.

I understand the majority's reluctance to extend the Supreme Court's approach to the taxation of nonrecourse debt cancellation taken in *Crane* v. *Commissioner*. Nevertheless, *Crane* is the law. In this case, we review the Commissioner's effort to extend the *Crane* doctrine to plug a breach in the dike holding back a potential flood of tax shelter schemes employing exaggerated depreciation and loss deduc-

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the sense that the seller no longer faces the prospect of losing them to his creditor. In contrast, it seems that property subject to nonrecourse indebtedness is in no sense "freed" but is actually "lost" when transferred subject to or relinquished in satisfaction of the debt. Further, we do not agree with Judge Williams' conclusion that the fair market value of the release "corresponds directly" with the fair market value of the property securing the nonrecourse indebtedness. As we noted in the text, Mrs. Crane benefited in that a release was a prerequisite to recovery of her $2500 equity. The fair market value of the release is a measure of that benefit. But because we remain unpersuaded that Mrs. Crane, in recovering her equity, "benefited" to the extent of $255,000, we think the fair market value of the release must be something substantially less.

We do agree with Judge Williams that whether we need only give great weight to the Commissioner's position or whether we may reject it only if it is unreasonable makes no difference. Because of our reservations about the logical underpinnings of *Crane*, we think that an extension of it would be unreasonable.

tion claims grounded on nonrecourse financing-inflated basis. The majority opinion discusses this "potential for abuse" inherent in our ruling, n.9 *supra*, yet concludes that the Commissioner's proposed solution, reflected in Treas.Reg. § 1.1001-2(b) (1980), constitutes an unacceptable "distort[ion of] the definition of amount realized."

With admiration for the logical rigor exhibited in the majority's analysis of this problem, I think it is essential to take heed of the constraints our Court operates under when we review an aspect of the intricate enforcement mechanism advised by the Internal Revenue Service to administer the tax laws. If we ignore the adoption of Treas.Reg. § 1.1001-2(b) during the pendency of this appeal[1] and the position asserted by the Internal Revenue Service as merely an administrative interpretation, our Court is obliged to give great weight to the Commissioner's position. *Compare United States* v. *Fisher*, 353 F.2d 396 (5th Cir. 1965) (appellate court is obliged to give "great weight" to Treasury Department's administrative construction of the National Firearms Act). If, on the other hand, we recognize that the Commissioner's interpretation before us on this appeal has now been elevated to the status of a regulation, we may invalidate it "only if it is unreasonable and inconsistent with the statute." *Delta Metalforming Co., Inc.* v. *Commissioner of Internal Revenue*, 632 F.2d 442, 449 (5th Cir. 1980) (per Judge Brown). In matters of tax code construction and administration, we must bear in mind that "[t]he choice among reasonable interpretations is for the Commissioner, not the Courts. *National Muffler Dealers Ass'n, Inc.* v. *United*

---

[1] **Treas.Reg. § 1001-2(b) was promulgated on December 11, 1980.**

States, 440 U.S. 472, 488, 99 S.Ct. 1304, 1312, 59 L.Ed.2d 519 (1979). Whether we regard the view advanced by the Commissioner on this appeal as a mere interpretation or a regulation makes no difference. In this case, the plain language of the statute conflicts with the Service's position.

Reliance on the literal language of the tax code is a precarious position, especially when dealing with *Crane*-like situations.[2] Nevertheless, it seems apparent to me that the question left dangling by footnote 37 of *Crane* is squarely answered by I.R.C. § 1001(b), which defines "amount realized" as "the sum of any money received plus the *fair market value* of the property (other than money) received" (emphasis added). Although the Supreme Court expressly avoided characterizing the taxable economic benefit a transferor of property receives when his transferee takes subject to a nonrecourse mortgage as either money or property, 331 U.S. at 14, 67 S.Ct. at 1054, Judge Learned Hand in the same case in lower court declared "it is the law . . . that . . . the release [of nonrecourse indebtedness] would have been 'property (other than money) received' within the meaning of § 111(b) [now I.R.C. § 1101(b)]." *Commissioner* v. *Crane*, 153 F.2d 504, 505 (2d Cir. 1945). Combing the freeing-of-assets theory underlying the cancellation of indebtedness cases, *see United States* v. *Kirby Lumber Co.*, 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131

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[2] One commentator on the *Crane* doctrine offered this admonition on tax code construction: "Everyday meanings are only of secondary importance when construing the words of tax statute and are very seldom given any weight when a more abstruse and technical meaning is available." Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; an Imaginary Supreme Court Opinion*, 21 Tax L.Rev. 159, 164 (1966).

(1931), with the *Crane* principle that recourse and nonrecourse indebtedness be treated alike under § 1001, the fair market value of the release corresponds directly to the fair market value of the property securing the nonrecourse indebtedness.[9] Therefore, § 1001(b) imposes tax liability for receipt of a release of nonrecourse indebtedness, but only to the extent of the fair market value of the property transferred subject to the nonrecourse mortgage.

The result compelled by the fair market value limitation of § 1001(b) is also compelled in this case involving partnership taxation by I.R.C. § 752(c), which inserts a parallel fair market value limitation on transfers of mortgaged property within and by a partnership. Again, the Service's view that § 752(c) operates independently of § 752(d), *see* n.8, *supra*, is at war with the plain language of the statute. Subsection (c) applies: "[f]or purposes of this section." Subsection (d) is part of § 752—"this section." Even if one were to adopt the *Millar* view and ignore the fair market value limitation of § 1001(b), the clear and specific imposition of a fair market value limitation in § 752(c) would control over § 752(d)'s general reference to the computation embracing the § 1001 definition in the partnership taxation context. Our reading of § 1001(b) is further justified because it does not permit the development of a disparity in the taxation of partnerships as opposed to other business entities.

---

[9] This reckoning echoes the Supreme Court's language, to which Footnote 37 was appended, in *Crane*: "we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit *in the amount of the mortgage* as well as the boot." 331 U.S. at 14, 67 S.Ct. at 1054 (footnote omitted) (emphasis added).

The result § 1001(b) and § 752(c) compel me to reach produces grave consequences for the equitable administration of the tax code. We abandon the certainty and predictability of calculations based on amounts specified in the nonrecourse mortgage instrument in favor of the elusive concept of fair market value. Under our decision, borrowers with personal liability receive less favorable treatment than nonrecourse borrowers on mortgaged property that declines in value. While I.R.C. § 465's "at risk" limitations on loss deduction from investments in certain speculative ventures may curb the potential for tax shelter abuses employing nonrecourse financing, § 465 does not reach real estate investments of the sort transferred by the Tufts partnership.

Our holding means that the Internal Revenue Service—or Congress—will have to retool the code mechanism for policing exaggerated depreciation and loss deduction claims grounded on a basis inflated by nonrecourse borrowing. Section 1001 and 752 simply do not authorize the administrative solution the Service seeks to defend here.

Crane is correct and does not warrant a restrictive interpretation. But the Commissioner's extension of *Crane* on review here collides directly with controlling statutory language when the fair market value of the property is less than the amount of the adjusted base, i.e. the amount of the nonrecourse debt less the deductions taken.

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 79-2258

JOHN F. TUFTS and MARY A. TUFTS, ET AL.,
PETITIONERS-APPELLANTS

versus

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Appeal from the United States Tax Court

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion July 27, 5 Cir. 1981, ——F.2d. ——).
(October 19, 1981)

Before BROWN, THORNBERRY and WILLIAMS, Circuit Judges.

PER CURIAM

(X) The Petition for Rehearing is DENIED and no member of that panel nor Judge of this Administrative Unit in regular active service having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the suggestion for Rehearing En Banc is DENIED.

( ) The Petition for Rehearing is DENIED and the judges in regular active service of this Administrative Unit having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the Petition for Rehearing En Banc is also DENIED.

( ) A member of this Administrative Unit in active service having requested a poll on the reconsideration in this cause en banc, and a majority of the judges in active service of said unit not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT

/s/ [Thornberry]
THORNBERRY
United States Circuit Judge

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 752. TREATMENT OF CERTAIN LIABILITIES.

(a) *Increase in Partner's Liabilities.*—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) *Decrease in Partner's Liabilities.*—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) *Liability to Which Property is Subject.*—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) *Sale or Exchange of an Interest.*—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

> (1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
>
> (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

* * * * *

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) [as redesignated and amended by Sec. 201(f)(1), Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 564] *General Rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

* * * * *

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

> (A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and
>
> (B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws.

* * * * *

Treasury Regulations on Income Tax, Sec. 1.1001-2 (b) (26 C.F.R.):

* * * * *

(b) *Effect of fair market value of security.* The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

* * * * *

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Joint Appendix

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No. 81-1536

In the Supreme Court of the United States

OCTOBER TERM, 1981

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS AND MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI
FILED FEBRUARY 16, 1982
CERTIORARI GRANTED MAY 3, 1982

In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-1536

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS AND MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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UNITED STATES TAX COURT
GENERAL DOCKET

Docket No. 1386-76

February 23, 1976—PETITION FILED: FEE PAID Feb. 23, 1976—Served Feb. 24, 1976

February 23, 1976—REQUEST FOR PLACE OF TRIAL at Dallas, TX. by petr.—GRANTED Feb. 23, 1976—Served Feb. 24, 1976

April 16, 1976—ANSWER by Resp. filed—Served April 19, 1976

June 7, 1976—ENTRY OF APPEARANCE by Ronald G. Williams as counsel for Petr. filed—Served June 8, 1976

June 8, 1976—REPLY by Petr. filed. (PM timely)—Served June 8, 1976

December 16, 1976—NOTICE OF TRIAL at Dallas, TX on Mar. 21, 1977.—Served Dec. 16, 1976

March 7, 1977—MOTION by Petr. for leave to file Motion to Compel Stipulation out of time. (Motion to Compel Stipulation LODGED) (C/S 3/3/77)—See Order Mar. 9, 1977

March 9, 1977—MOTION by Petr. to compel stipulation (Embodying Proposed Stipulation) (C/S 3/3/77)—See Order Mar. 9, 1977

March 9, 1977—ORDER, that Petr's motion for leave to file motion to compel stipulation out of time is granted and the Clerk is to file Petr's Motion to Compel Stipulation (Embodying Proposed Stipulation) as of this date. It is further ORDER, that Petr's Motion to Compel Stipulation is granted in that Resp. is to submit his response on or before March 21, 1977 and to show cause on March 21, 1977 at Dallas, Tx. as to Why the proposed stipulation incorporated in Petr's motion should not be received into evidence.—Served March 9, 1977

March 21, 24, 1977—TRIAL at Dallas, TX before Judge Simpson. 3/21/77 Petr's. motion for leave to amend pleading filed—GRANTED.—Served Apr. 8, 1977. 3/21/77 Amended petition filed.—Served Apr. 8, 1977. 3/21/77 Joint motion to consolidate Docket Nos. *1386-76, 1429-76, 1432-76, 1434-76, 1435-76 and 1436-76* for trial. briefing and opinion filed—GRANTED.—Served Apr. 8, 1977. 3/21/77 Resp's. notice of objection to compel stipulation filed.—Served April 8, 1977. 3/24/77 Stipulation of Facts with joint exhibits filed. 3/24/77 Hearing on Order to Show Cause dated Mar. 9, 1977—See Order. Record held open for resp. to file answers to amended petitions by May 5, 1977. PETR'S OPENING BRIEF DUE: May 23, 1977. RESP'S BRIEF IN ANSWER DUE: July 22, 1977. PETR'S REPLY BRIEF DUE: Aug. 22, 1977. SUBMITTED TO JUDGE SIMPSON

March 24, 1977—ORDER, that the Court's Order to Show Cause dated Mar. 9, 1977 is discharged and the facts and evidence embodies in petr's. motion to compel stipulation are not deemed stipulated for purposes of this case.—Served Apr. 8, 1977

April 15, 1977—TRANSCRIPT of March 21, 24, 1977 received. (Vol. 3)

May 24, 1977—MOTION by Petr. for extension of time for two weeks TO: June 6, 1977 to file Original Brief. (No Obj. Resp.) (C/S 5/20/77) (P.M. Timely)—GRANTED May 25, 1977—Served May 27, 1977

June 6, 1977—ANSWER TO AMENDED PETITION filed by Resp. (Leave to file Granted)—Served June 7, 1977

June 8, 1977—BRIEF filed by petr. (P.M. Timely)—Served June 9, 1977

August 5, 1977—BRIEF IN ANSWER filed by resp.—Served Aug. 8, 1977

August 29, 1977—REPLY BRIEF filed by petr.—Served Aug. ??, 1977

August 23, 1978—FINDINGS OF FACT AND OPINION filed, Judge Simpson. Decision will be entered under Rule 155. Served Aug. 23, 1978

March 5, 1979—AGREED COMPUTATION filed.

March 6, 1979—DECISION ENTERED, Judge Simpson. APPELLATE PROCEEDINGS—Served Mar. 6, 1979

April 23, 1979—NOTICE OF APPEAL to U.S.C.A., Fifth Circuit, filed by Petitioners.—Served Apr. 24, 1979

April 24, 1979—NOTICE of Filing with copy of notice of appeal sent to Mr. Stuart E. Seigel, Chief Counsel.—Served Apr. 24, 1979

April 24, 1979—NOTICE, to parties, of assembling and date for transmission or the record.—Served Apr. 24, 1979

UNITED STATES TAX COURT

Docket No. 1386-76

JOHN F. TUFTS and MARY A. TUFTS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION

Filed: [February 23, 1976]

The petitioners hereby petition for a redetermination of the deficiency asserted by the Commissioner of Internal Revenue in his notice of deficiency, bearing symbols DD:DALLAS:A:S:90-D:306, dated November 24, 1975, and as a basis for this proceeding allege as follows:

1. Petitioners are husband and wife whose mailing address is Route 1, Box 1310, Dallas, Texas. The return for the period here involved was filed with the Southwest Regional Service Center, Austin, Texas.

2. The notice of deficiency (a copy of which includes so much of the statement and schedules accompanying the notice as is material, is attached and marked Exhibit "A") was mailed to petitioners on or after November 24, 1975, and was issued by the Internal Revenue Service Office at Dallas, Texas.

3. The deficiency, all of which is in controversy, is in income tax in the amount of Thirty Thousand Four Hundred Five Dollars ($30,405) for the calendar year ending December 31, 1972.

4. The determination of tax asserted in the following notice of deficiency (Exhibit "A") is based upon the following errors:

a. The Commissioner erred in determining that petitioners realized income of Fifty-Nine Thousand Four Hundred Ninety-Eight Dollars and Fifty Cents ($59,498.50) from a sale of their interest in Westwood Townhouses partnership which was not reported in their income tax return.

b. The Commissioner erred in determining that petitioners' taxable income was increased in the amount of Fifty-Nine Thousand Four Hundred Ninety-Eight Dollars and Fifty Cents ($59,498.50) in 1972.

c. The Commissioner erred in determining that petitioners realized Section 1250 gain on a sale in the amount of Eleven Thousand Seven Hundred Seventy-Five Dollars ($11,775) in the year 1972.

d. The Commissioner erred in determining that petitioners realized Four Hundred Sixty-Two Thousand Eight Hundred Seventy-Five Dollars ($462,875) of "Sales Price" by reason of liabilities assumed by a purchaser in 1972.

e. The Commissioner erred in determining petitioners' Adjusted Basis in the partnership to be Three Hundred Fifty-Five Thousand Six Hundred Fifty Three ($355,653) Dollars.

f. The Commissioner erred in determining that petitioners realized income from Earl Mizell and Associates in the amount of Eleven Thousand One Hundred Thirty-Five ($11,135.73) Dollars and Seventy-Three Cents.

g. The Commissioner erred in determining that petitioners realized income from sale of cattle in the amount of Forty-Four Thousand Four Hundred Nineteen ($44,419.56) Dollars and Fifty-Six Cents.

h. The Commissioner erred in determining that petitioners realized income from grain sales in the amount of Five Thousand Four Hundred Eighty-One ($5,481.98) Dollars and Ninety-Eight Cents.

i. The Commissioner erred in determining that petitioners realized income from Fertilizer sale in the amount of One Thousand Eight Hundred Thirty-Five ($1,835.60) Dollars and Sixty Cents.

j. The Commissioner erred in determining that petitioners are liable for the following penalties: §6651(a) $8,209.25; §6653(a) $1,519.24.

5. The facts upon which petitioners rely as the basis of this proceeding are as follows:

a. Westwood Townhouses ("the partnership") was, during 1972, a Texas general partnership, taxable under the provisions of Subchapter K, I.R.C., 1954, as amended.

b. More than six (6) months prior to August 28, 1972, petitioners acquired and held a general partnership interest in the partnership.

c. The partnership owned an apartment complex known as Westwood Townhouses ("the project").

d. The project had been constructed by or for the partnership with funds borrowed by the partnership on a no-personal liability loan in the original principal amount of $1,851,500 ("the mortgage loan").

e. Neither the partnership nor any of its partners assumed personal liability for payments due under the mortgage loan.

f. On August 28, 1972, petitioners sold their partnership interest in the partnership to an unrelated individual ("the sale").

g. The sale was negotiated at arms length and for full fair market value.

h. the purchaser of petitioners' partnership interest did not assume personal liability for payments due under the mortgage loan.

i. The consideration for the sale was the purchaser's agreement to pay attorney's fees and costs of sale not to exceed $250.

j. On the date of the sale, the fair market value of the project was not in excess of $1,400,000.

k. On the date of the sale, petitioners' cost basis in their partnership was $2,771.00.

l. Petitioners realized a deductible long term capital loss by reason of the sale in an amount equal to the full amount of their cost basis, which loss was not claimed as a deduction on their 1972 income tax return, but which is hereby claimed.

m. Other items of income and expense which were increased or reduced in Exhibit A were properly reported on petitioners' income tax return as it was originally filed.

WHEREFORE, petitioners pray that this Court hear this proceeding and determine that there is no deficiency for the calendar year 1972, and that an overpayment of tax was made for the calendar year 1972 for which refund is due to petitioners in an amount to be determined by the Court, and grant such other and further relief as to which petitioners may be entitled by law.

Respectfully submitted,

/s/ Ronald M. Mankoff
RONALD M. MANKOFF

/s/ Charles M. Meadows, Jr.
CHARLES M. MEADOWS, JR.

/s/ Robert Edwin Davis
ROBERT EDWIN DAVIS

COUNSEL FOR PETITIONERS
3900 First National Bank Building
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Phone: 214/748-0074
Dated: February 13, 1976

UNITED STATES TAX COURT

Docket No. 1386-76

JOHN F. TUFTS and MARY A. TUFTS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Denies the allegations of paragraph 2 of the petition; alleges that the notice of deficiency (a copy of which was attached to the petition and marked Exhibit "A") was mailed to petitioners on November 24, 1975, and was issued by the Internal Revenue Service Office at Dallas, Texas.

3. Denies the allegations of paragraph 3 of the petition; alleges that the deficiency, all of which is in controversy, is in income tax in the amount of Thirty Thousand Three Hundred Ninety-eight Dollars Seventy-five Cents ($30,398.75) plus addition to the tax of Eight Thousand Two Hundred Nine Dollars Twenty-five Cents ($8,209.25) under *Int. Rev. Code of 1954*, § 6651(a) and One Thousand Five Hundred Nineteen Dollars Twenty-four Cents ($1,519.24) under *Int. Rev. Code of 1954*, § 6653(a) for the calendar year ended December 31, 1972.

4. a to j, inclusive. Denies the Commissioner erred as alleged in subparagraphs a to j, inclusive, of paragraph 4 of the petition.

5. a to c, inclusive. Admits the allegations of subparagraphs a to c, inclusive, of paragraph 5 of the petition.

d and e. Denies the allegations of subparagraphs d and e of paragraph 5 of the petition for lack of information.

f and g. Admits the allegations of subparagraphs f and g of paragraph 5 of the petition.

h. Denies the allegations of subparagraph h of paragraph 5 of the petition for lack of information.

i to m, inclusive. Denies the allegations of subparagraphs i to m, inclusive, of paragraph 5 of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency and additions thereto determined by the respondent be in all respects approved.

Meade Whitaker
Chief Counsel
Internal Revenue Service

April 9, 1976

By: /s/ Ralph V. Bradbury, Jr.
Ralph V. Bradbury, Jr.
Assistant Regional Counsel
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UNITED STATES TAX COURT

Docket No. 1386-76

JOHN F. TUFTS and MARY A. TUFTS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

REPLY

Filed June 8, 1978

Petitioners, by way of reply to the affirmative allegations set forth in the answer filed by the Respondent in the above captioned case, deny, and allege as follows:

3. Deny the allegations of paragraph 3 of the Answer, and affirmatively state that the amount in controversy includes the deficiency in the income tax in the amount of $30,398.75, plus additions of tax of $8,209.25, and $1,519.24, coupled with the deductible long-term capital loss of the petitioners in the amount of $2,771.00.

6. Deny generally each and every allegation of the Answer not hereinbefore, specifically admitted, qualified or denied.

WHEREFORE, petitioners pray that the court hear this case, and

1. Determine that there is no deficiency in income tax due from the petitioners for the calendar year of 1972.

2. Determine that there is no statutory addition to the tax under the provisions of Section 6651(a) and Section 6653(a) of the Internal Revenue Code of 1954 due from the petitioners for the calendar year 1972, and

3. Determine that the petitioners realized a deductible long-term capital loss by reason of the sale of their partnership interest in an amount equal to $2,771.00, which loss is not claimed as a deduction on their 1972 income tax return, but which is hereby claimed, and

4. Grant such other and further relief as petitioners may be entitled at law.

Respectfully submitted,

/s/ Ronald M. Mankoff
RONALD M. MANKOFF

/s/ Charles M. Meadows, Jr.
CHARLES M. MEADOWS, JR.

/s/ Robert Edwin Davis
ROBERT EDWIN DAVIS

UNITED STATES TAX COURT

Docket Nos. 1386-76, 1429-76,
1432-76, 1434-76,
1435-76, 1436-76

JOHN F. TUFTS and MARY A. TUFTS,
CLARK, INC.,
WILLIAM T. STEGER and RUTH C. STEGER,
ROBERT C. AUSTIN, SR. and BIRDIE L. AUSTIN,
J. C. PELT and JEWEL PELT,
JAMES E. STEPHENS and EULA F. STEPHENS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Filed: [March 24, 1977]

STIPULATION OF FACTS

The parties hereby stipulate and agree that for purposes of these consolidated cases the following facts and exhibits attached hereto and made a part hereof may be taken as true, subject to the rights of the parties to introduce other and further evidence not inconsistent with this stipulation.

1. Petitioners John F. Tufts and Mary A. Tufts [hereinafter jointly referred to as Tufts] are husband and wife and maintained their residence in Dallas, Texas, when they filed the petition herein. They filed their joint Federal Income Tax Return for the taxable year 1972 with the Director of Internal Revenue for the District of Dallas. Attached hereto as Joint Exhibit 1-A is a copy of the joint return for the year 1972.

2. Petitioner Clark, Inc., is a Texas corporation whose mailing address at the time of filing the petition herein was 210 North Main, Duncanville, Texas. Its United States Corporation Income Tax Return for the fiscal year ended July 31, 1973, was filed with the Director, Internal Revenue Service Center, Austin, Texas. Attached hereto as Joint Exhibit 2-B is a copy of the corporate tax return for the year ended July 31, 1973.

3. Petitioners William T. Steger and Ruth C. Steger [hereinafter jointly referred to as Steger] are husband and wife and maintained their residence in Dallas, Texas, when they filed the petition herein. They filed their joint Federal Income Tax Return for the taxable year 1972 with the Director, Internal Revenue Service Center, Austin, Texas. Attached hereto as Joint Exhibit 3-C is a copy of the joint return for the year 1972.

4. Petitioners Robert C. Austin, Sr. and Birdie L. Austin [hereinafter jointly referred to as Austin] are husband and wife and maintained their residence in Dallas, Texas, when they filed the petition herein. They filed their joint Federal Income Tax Return for the taxable year 1972 with the Director, Internal Revenue Service Center, Austin, Texas. Attached hereto as Joint Exhibit 4-D is a copy of the joint return for the year 1972.

5. Petitioners J. C. Pelt and Jewel Pelt [hereinafter jointly referred to as Pelt] are husband and wife and maintained their residence in Duncanville, Texas, when they filed the petition herein. They filed their Joint Federal Income Tax Return for the year 1972 with the Director, Internal Revenue Service Center, Austin, Texas. Attached hereto as Joint Exhibit 5-E is a copy of the joint return for the year 1972.

6. Petitioners James E. Stephens and Eula F. Stephens [hereinafter jointly referred to as Stephens] are husband and wife and maintained their residence in Duncanville, Texas, when they filed the petition herein. They filed their Joint Federal Income Tax Return for the taxable year 1972 with the Director, Internal Revenue Service Center, Austin, Texas. Attached hereto as Joint Exhibit 6-F is a copy of the 1972 joint income tax return.

7. On August 1, 1970, Pelt and Clark, Inc., entered into a General Partnership Agreement. The partnership was known as Westwood Townhouses. Attached hereto as Joint Exhibit 7-G is a copy of the partnership agreement.

8. On August 7, 1970, the partnership entered into a Building Loan Agreement with Farm & Home Savings Association, whereby Farm & Home Savings Association agreed to loan the partnership $1,851,500.00 for the construction of a 120-unit apartment complex in Duncanville, Texas. On August 7, 1970, the partnership also executed a Deed of Trust and a Deed of

Trust Note in favor of Farm & Home Savings Association. Attached hereto as Joint Exhibits 8-H, 9-I and 10-J are copies of the Building Loan Agreement, Deed of Trust, and Deed of Trust Note, respectively.

9. The apartment complex was endorsed for mortgage insurance under § 221(d)(4) of the Federal Housing Act.

10. On August 21, 1970, the partnership agreement between Pelt and Clark, Inc., was amended so as to admit Tufts, Steger, Stephens and Austin to the partnership. Attached hereto as Joint Exhibit 11-K is a document entitled Amendment No. I to Agreement Of General Partnership Of Westwood Townhouses.

11. As a result of the nonrecourse liability of the partnership, each partner's basis on August 21, 1970, was as follows:

Partner	*Basis*
Pelt	$462,875.00
Clark, Inc.	185,150.00
Austin	138,862.50
Stephens	138,862.50
Tufts	462,875.00
Steger	462,875.00

12. During the taxable year 1970 each partner claimed as his allocable share the following amounts as ordinary losses resulting from the partnership operations:

Partner	*Amount of Loss*
Pelt	$21,946.00
Clark, Inc.	8,779.00
Austin	6,584.00
Stephens	6,584.00
Tufts	21,946.00
Steger	21,946.00

Attached hereto as Joint Exhibits 12-L, 13-M, 14-N, 15-O, 16-P, 17-Q and 18-R are copies of the 1970 income tax returns for Pelt, Clark, Inc., Austin, Stephens, Tufts, Steger and the partnership return, respectively.

13. At the end of taxable year 1970 the individual partner's basis was as follows:

Partner	*Basis*
Pelt	$440,929.00
Clark, Inc.	176,371.00
Austin	132,278.50
Stephens	132,278.50
Tufts	440,929.00
Steger	440,929.00

14. The apartment complex was completed on or about August 21, 1971.

15. During the taxable year 1971 the individual partners made the following contributions to the partnership:

Partner	*Amount of Contribution*
Pelt	$21,439
Clark, Inc.	308
Austin	831
Stephens	231
Tufts	2,771
Steger	2,771

16. During the taxable year 1971 each partner claimed as his allocable share the following amounts of ordinary losses resulting from the partnership operations, exclusive of first-year depreciation and exclusive of the depreciation for the year 1971:

Partner	*Amount of Loss*
Pelt	$40,409.00
Clark, Inc.	16,163.40
Austin	12,122.80
Stephens	12,122.80
Tufts	40,409.00
Steger	40,409.00

Attached hereto as Joint Exhibits 19-S, 20-T, 21-U, 22-V, 23-W, 24-X and 25-Y are copies of the 1971 income tax returns for Pelt, Clark, Inc., Austin, Stephens, Tufts, Steger and its partnership return, respectively.

17. During the taxable year 1971 each partner claimed the following as his allocable share of first-year depreciation from the partnership operation:

Partner	*First-Year Depreciation*
Pelt	$96.00
Clark, Inc.	38.00
Austin	29.00
Stephens	29.00
Tufts	96.00
Steger	96.00

18. During the taxable year 1971 each partner claimed as his allocable share of depreciation for 1971 the following amounts:

Partner	*1971 Depreciation*
Pelt	$15,334.00
Clark, Inc.	6,133.60
Austin	4,600.20
Stephens	4,600.20
Tufts	15,334.00
Steger	15,334.00

19. At the end of the taxable year 1971 the following reflects the adjusted basis of each partner in the partnership:

Partner	*Adjusted Basis*
Pelt	$406,529.00
Clark, Inc.	154,344.00
Austin	116,357.50
Stephens	115,757.50
Tufts	387,861.00
Steger	387,861.00

20. During the taxable year 1972 the individual partners made the following contributions to the partnership:

Partner	Amount of Contribution
Pelt	$15,861
Clark, Inc.	0
Austin	0
Stephens	0
Tufts	0
Steger	0

21. During the taxable period January 1, 1972 ending August 28, 1972, each partner claimed as his allocable share the following amounts as ordinary losses resulting from the partnership operation, exclusive of depreciation:

Partner	Loss
Pelt	$20,629.25
Clark, Inc.	8,251.50
Austin	6,188.38
Stephens	6,188.38
Tufts	20,629.25
Steger	20,629.25

Attached hereto as Joint Exhibit 26-Z is a copy of the partnership return for the taxable period January 1, 1972 ending August 28, 1972.

22. During the taxable period January 21, 1972, ending August 28, 1972, each partner claimed the following as his allocable share of depreciation for the taxable period in 1972:

Partner	Depreciation Claimed
Pelt	$11,578.75
Clark, Inc.	4,631.50
Austin	3,473.62
Stephens	3,473.62
Tufts	11,578.75
Steger	11,578.75

23. At the end of the taxable period January 1, 1972, to August 28, 1972, the following reflects the adjusted basis of each partner in the partnership:

Partner	*Adjusted Basis*
Pelt	$390,182.00
Clark, Inc.	141,461.00
Austin	106,695.50
Stephens	106,095.50
Tufts	355,653.00
Steger	355,653.00

24. On August 28, 1972, the liability owed on the nonrecourse note by the partnership was $1,851,500.

25. On August 28, 1972, Pelt, Clark, Inc., Austin, Stephens, Tufts and Steger each sold their respective partnership interest to Fred Bayles. Attached hereto as Joint Exhibits 27-BA, 28-BB, 29-BC, 30-BD, 31-BE, 32-BF, 33-BG are copies of Memorandum Agreement of Sale and Indemnification, and Sale and Assignment of Partnership Interest Agreements executed by Pelt, Clark, Inc., Austin, Stephens, Tufts and Steger, respectively.

26. Petitioners object to stipulation paragraphs 11, 12, 13, 15, 16, 17, 18, 19, 20, 21 and 22, except for exhibits referred to therein which petitioner has no objection to, on the grounds of relevancy, materiality and lack of pleadings to support the stipulations.

27. Petitioners in Docket No. 1386-76 concede allegations of error 4(f), 4(g), 4(h) and 4(i) of their petition.

28. Respondent concedes petitioners' allegation of error 4(j) in Docket No. 1386-76.

/s/ Charles M. Meadows, Jr.
CHARLES M. MEADOWS, JR.
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Bank Building
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March 18, 1977

Charles L. Saunders, Jr.
Acting Chief Counsel
Internal Revenue Service

By: /s/ Ralph V. Bradbury, Jr.
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Transcript of Proceedings—March 24, 1977 Opening Statement of Ronald M. Mankoff, counsel for the taxpayers.

* * * * *

[8] Mr. Mankoff: Thank you, Your Honor. We are representing petitioners who are Clark, Inc., a Texas Corporation, J. C. Pelt, Jr., who is generally known as Clark,—

The Court: Generally known as what?

Mr. Mankoff: Clark Pelt.

The Court: Uh-huh.

Mr. Mankoff: James Stephens, who is also in the Courtroom today, Mr. and Mrs. John Tufts, Mr. and Mrs. Robert Austin, and Mr. and Mrs. William Steger and of course, the wives of Mr. Pelt and Mr. Stephens as well, who are here because of their filing joint returns. Unfortunately, because several witnesses are from out of town, the case will not proceed in a normally orderly fashion and so I thought I might take this opportunity to outline the facts to aid the Court in following this testimony as it comes forth.

[9] The Court: Fine.

Mr. Mankoff: In August of 1970,—on August 1st as a matter of fact, a general partnership was formed by Clark, Inc. and Clark Pelt. Clark, Inc. was his wholly owned corporation, it owned 90% of the partnership—excuse me—10% of the partnership and Mr. Pelt himself owned 90% of the partnership. Thereafter, this partnership arranged borrowings of $1,851,000.00 for the purpose of building a 120 unit FHA apartment house under Section 221(d)4, a particular provision of the FHA laws. Later that month, four additional partners were admitted by amendment to the general partnership. They became general partners. Construction of the apartment building was undertaken by Mr. Pelt and by Clark, Inc. as the general contractors and about a year later in August of 1971, the apartment was completed. In the meantime during 1970 and during 1971, there were operating losses realized by the partnership. There were also depreciation losses as indicated by the stipulations, to which the Court has just admitted. I might mention at this point that these deductions are not here in issue. That the operation of the partnership as a losing business during these years did not result in any disallowance of loss. We recognize that this country has gone through a period of the tax shelter so that there's an extreme sensitivity to the question of this kind of deduction. We believe hopefully that this period is behind us but we know it has left [10] its mark certainly on the tax laws. That mark has properly been made by the Congress in rather sweeping changes. But we do submit that when the Courts try to protect the revenues rather than to simply apply the law as it is written in the code on the regulations, that the result has been confusion and in at least one case, chaos. And so it's our hope that we can approach this case with the view of—of hindsight knowing that commonly lawyers and Judges can apply the law without fear that some unexpected benefit may be enjoyed when we realize that the code is not perfect, the Congress recognizes that and is doing its best to correct those imperfections but we, that is the attorneys and the Courts, cannot amend the law and can only deal with the law as is presently written. It is our position that this case is governed by Sub-Chapter K of the Internal Revenue Code, which since 1954, has dealt with the taxation of partnerships and under those provisions the answer is as proposed by the petitioner. But let me continue with the facts if I may. The partners contributed cash from time to time which made up operating deficits of this unsuccessful business until finally in August of 1972 around two years after the initiation of the venture, with occupancy of the apartment never achieving 75%, with rents reduced, with utility costs increased, these businessmen finally gave up and it is stipulated that each partner sold his interest in the [11] partnership to Mr. Fred Bayles, and unrelated party, whom they did not know. Let me point out also that the fact of this sale, thereby qualifying this transaction for capital gains and whatever character or capital losses I might say, if a loss was realized, is uncontested by the Government. So that that issue is not in the case. The question presented here is whether the partners must treat the partnerships debt for which they were not liable and for which the partnership was not liable as part of the amount realized by them on the sale of their partnership interests. The petitioners say no. Because this sale under Sub-Chapter K must be tracked through the provisions basically of Section 752. Now, the Government will say and we will—or agree that Section 752(d) does provide that a sale of partnership interest shall be treated for purposes of liabilities as a sale of a property not associated with the partnerships. But that Section 752(d) is expressly limited by Section 752(c) which says that and I quote—"For purposes of this section, a liability to which property is subject shall to the extent of the fair market value of such property be considered as a liability of the owner of the property" end quote. This section which reflects perhaps some of the thinking that the United States Supreme Court reflected in the Crane case and particularly at footnote 37 and which reflects we believe the thinking in Parker versus Delaney as cited by the First Circuit [12] shortly thereafter and which reflects we think sound accounting and economic reflection of nonrecourse liability, must apply to this transaction since we had a sale of partnership interest. I might mention that Section 741 also deals with this and says that the sale or exchange of a partnership interest shall be treated as a capital transaction, except to the extent that Section 751 might intrude. And so our position is that the fair market value of the apartment house which stood as the sole source of repayment of the partnership's debt was not over $1,400,000.00 in August of 1972, at the time of this transaction. That since the Government has agreed and stipulated that the aggregate outside bases of the partners in their partnership interests was $1,455,740.00—that therefore the disposition of this property under the Internal Revenue Code and Sub-Chapter K resulted in a loss to these partners of approximately $55,000.00. Now, these partners did not claim a loss deduction on their return although they disclosed fully the fact that the transaction and that a loss had resulted but on the return, the position was taken and noted that this loss was not claimed. At this time and in our pleadings, we are taking the position that the Court should review and decide whether in fact this loss should be allowed. There is to our knowledge no prohibition against its deductibility and if the code be followed then a loss resulted and in the [13] absence of some reason for not allowing that loss, we would submit that it would be entirely appropriate to allow it. We recognize it would be a capital loss under Section 741.

* * * * *

[66] Testimony of Irwin R. Rose—Direct

* * * * *

Q When did you acquire Westwood Townhouses?
A We closed title in September, 1976.

Q How did you become aware of that apartment complex?

A I became—after I purchased Las Casitas Apartments here in 1975, I inspected some of the comparable competition in the general area. I became familiar with some of the HUD officials here in the Dallas office that I was dealing with in connection with Las Casitas. And somewhere in the conversation it came—it became evident that the Westwood * * * [67] had been acquired by HUD and would be coming on the market at some future time and I might have an interest in it. I should look at it and watch for it. If I did have an interest, I should watch for it if it was ever offered for sale.

Q Were you then notified of a pending sale of the property?

A Yes.

THE CLERK: Respondent's Exhibit BI marked for identification.

MR. MEADOWS: Your Honor, at this time, petitioners would agree to stipulate Exhibit BI in evidence.

THE COURT: You have no objections to it?

MR. MEADOWS: No, Your Honor.

THE COURT: All right. BI is admitted.

MR. JORDAN: Mr. Rose, I hand you what's been admitted into evidence as Respondent's Exhibit BI and ask you if you have ever seen that document before or a reasonable proximity of that document?

A I've seen the original, yes.

Q What is that document, Mr. Rose?

A This is the HUD prospectus on the Westwood Townhouses that was circulated when they were contemplating the sale.

Q Is this what you received—

A Yes.

[68] Q —advising you of the impending sale of the property?

A Yes.

* * * * *

[83] Testimony of John Clark Pelt, Jr.—Direct

* * * * *

Q All right. It's been stipulated also that on August 21st, about three weeks after your original partnership was formed and about two weeks after you had arranged the building and loan—the building loan with Farm and Home Savings, that you added four additional general partners?

A That's true.

[84] Q All right. That was John Tufts, Bill Steger, Jim Stephens and Bob Austin. Can you tell me, who is Bob Austin?

A Bob Austin is a friend of mine that I'd known several years. He had been with the—one of the local savings and loan companies here that I was doing business with.

Q Uh-huh.

A And—and I'd been to his home—he was a personal friend. I'd been—

Q Is that why he became a partner in this entity?

A Yes, sir. This is why.

Q Who's Jim Stephens?

A Jim Stephens is my stepson.

* * * * *

[85] A Who was Jim Stephens?

THE COURT: No. No, why did he become a member of the partnership? Because of his relationship to you?

THE WITNESS: Well, because of his relationship and then this might get into other things of that, that—not pertaining to this case I think. In other words, because I wanted to bring him in. Is that a satisfactory answer? I wanted to bring him.

MR. MANKOFF: Yes, satisfactory to me.

A For several reasons—for a loss or gain, whichever the future might hold, for this reason—I wanted him to come in.

Q Who was Bill Steger?

A He was another person that I had known a long time. I had known his father and my father and his fathers were—were friends when I was born. And I've known the man a long time, and—

* * * * *

[86] A I need a letter of credit in order to built these apartments, and I was not strong enough by myself to establish that letter of credit so it became necessary for me to relinquish part of the interest in the project to other people to get a letter of credit and financing and so forth.

Q Did Mr. Steger help you to get that letter of credit?

A Yes, sir, he did.

Q How about John Tufts? Who was John Tufts?

A John Tufts came in for the same reason that Mr. Steger did. He is a nephew of mine that--but he is a successful businessman and they could go on this letter of credit at First National Bank in Duncanville that entitled me to—to build the project.

* * * * *

[87] A No. The cost test was very thorough. I had a cost test prepared by a professional estimator, Mr. Earl Jones. By being in the business many years, I made my own estimate. My son had been in this—in fact, this was his education as a—in a—to do this and our estimate was very accurate and it worked out unbelievably close in the amount of materials that we bought. We didn't run short or didn't run over. It was almost—almost as good an estimate [88] as you can ask for. It was just near perfect.

* * * * *

[89] the units rented? Was there any problem in getting units rented in this apartment house back there in 1972?

A Yes, there was.

Q Excuse me—excuse me 1971?

A Yes, there was a problem.

Q All right. Why—excuse me—why was that, Mr. Pelt?

A Well, it—it seemed at that time we had hit an economy downturn and the supply of apartments was greater than the demand of renters at that time and it was exceptionally hard to get enough people to fill the apartments.

* * * * *

[90] A Well, we—we couldn't rent them for the price—the maximum price that was set by FHA or HUD, then we lowered the rent to try to entice more people.

* * * * *

[92] Mr. Mankoff: Was there ever enough cash flow out of this project to make payments on the mortgage?

A No.

Q Did other apartment houses in the area—in that area of Dallas also reduce rents at about that time?

A To the best of my knowledge, they did.

* * * * *

[95] A Well, when we couldn't make the payments and it was at the point of foreclosure or there was talking of foreclosing and they didn't want to foreclose if—

Q Who didn't—excuse me—who didn't want to foreclose?

A FHA.

Q All right. Go ahead.

* * * * *

[96] A Or HUD—whoever—when I say FHA or HUD, whoever was—which is appropriate here.

Q All right.

A They didn't want to foreclose if there was any way we could work out a partial payments or anything—anything to keep from taking the apartments back until maybe the economy might improve. And we just verbally—agreements or we discussed the fact. Whether it was an agreement or not—I won't say it wasn't an agreement. We discussed the fact of making partial payments of what money was left after we had paid all operating expenses monthly from FHA to turn the rest of that over to the FHA as payments.

Q Did your operation of the property ever improve to such an extent that you could make partial payments on that mortgage?

A We might have made partial payments. The cash monthly flow was not enough—we couldn't have made consistently full monthly payments.

* * * * *

[110] Testimony of John Clark Pelt, Jr.—Cross

* * * * *

Q I believe so. What was the actual construction cost for Westwood Townhouses?

A I'd have to have some figures before me. I can tell you approximately. I don't know what all you include in construction cost. You've—

Q What do you conclude—

A —got land cost, you've got a lot of other costs and then you've got the brick and mortar cost. Now, what's

* * * * *

[111] your question?

Q Adding those together?

A Well, in this case, it would be the total amount of the loan.

Q You spent the total amount of the loan in constructing the project, is that correct?

A Yes, sir. True.

* * * * *

[170] Testimony of Fred M. Bayles—Cross

* * * * *

Q When you stated that you had determined the property—you were offered the property for a million eight hundred and fifty thousand dollars, that's not a mill eight hundred and fifty thousand dollars cash, it is?

A Cash or cash worth.

Q Well, let's talk about what you mean by cash worth for a minute. Does that include a no personal liability note?

* * * * *

[171] A Still cash worth.

Q That's what I'm asking.

A If I buy that suit to you, whether I sell it to you on a Bankamericard or you pay me cash, it's still money worth.

Q That's true except to the extent that this suit is only worth $50.00 and you're not personally obligated to pay for it.

A I'm obligated to pay for it unless I would stop wearing it.

Q I think that's right. And you decided in fact that you wanted to stop wearing Westwood Townhouses in the spring of '74 when you let it go to foreclosure.

A That's correct.

Q And why did it go to foreclosure?

A Because I wouldn't come out of my pocket with enough money to keep it going.

Q The project itself was not generating enough income to satisfy its debt at that time?

A That's correct.

* * * * *

EXHIBIT B1

You are invited to inspect . . .

WESTWOOD TOWNHOUSES

located at 306 W. Center Street, Duncanville, Texas - Convenient to schools, churches, hospitals, shopping and transportation.

FOR SALE BY PUBLIC OFFERING

U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT INVITES BIDS FOR THIS PROJECT TO BE TENDERED IN THE MANNER INDICATED. ALL BIDS ARE NET TO HUD. BIDDING INSTRUCTIONS MUST BE OBTAINED FROM THE UNDERSIGNED. TO QUALIFY FOR CONSIDERATION EACH BID ON ITS FACE SHALL BE FIRM, UNCONDITIONAL, RESPONSIVE, FIXED IN ONE AMOUNT CERTAIN AND NOT IN THE ALTERNATIVE.

MINIMUM PRICE : $1,200,000
MAXIMUM MORTGAGE: $1,080,000
REQUIRED DEPOSIT : $ 50,000 WITH BID

NOTE: In this offering, provision is made to permit the Maximum Mortgage to be increased in relation to the amount bid as set out in Nos. 2, 3 and 4 below:

1. A BID AT THE MINIMUM PRICE OF $1,200,000 WILL RESULT IN A MAXIMUM MORTGAGE OF $1,080,000
2. BID OF $1,200,000 BUT NOT IN EXCESS OF $1,320,000
   MAXIMUM MORTGAGE $1,080,000 PLUS 85% OF BID IN EXCESS OF $1,200,000
3. BID OF $1,320,000 BUT NOT IN EXCESS OF $1,440,000
   MAXIMUM MORTGAGE $1,182,000 PLUS 75% OF BID IN EXCESS OF $1,320,000
4. BID IN EXCESS OF $1,440,000
   MAXIMUM MORTGAGE $1,272,000 PLUS 70% OF BID IN EXCESS OF $1,440,000

FORM FOR COMPUTING MORTGAGE AMOUNT AND DOWN PAYMENT IS INCLUDED IN THE BIDDING INSTRUCTIONS.

NO CONSIDERATION WILL BE GIVEN TO A BID SUBMITTED BY ANY BIDDER CURRENTLY SUSPENDED OR DEBARRED FROM PARTICIPATING IN HUD PROGRAMS.

SEALED BIDS WILL BE RECEIVED AND
PUBLICLY OPENED AT 11:00 A.M. LOCAL TIME ON

JULY 21, 1976

IN ROOM 9252
OFFICE OF PROPERTY DISPOSITION
HOUSING MANAGEMENT
U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
451 - 7TH STREET, S. W.
WASHINGTON, D. C.

PROJECT INFORMATION

WESTWOOD TOWNHOUSES CONSISTS OF TWENTY 2-STORY WALK-UP BUILDINGS CONTAINING 120 UNITS PLUS A ONE-STORY COMMUNITY BUILDING LOCATED AT 306 W. CENTER STREET, DUNCANVILLE, TEXAS. IT WAS CONSTRUCTED IN 1970 AND ACQUIRED BY HUD JULY 2, 1975.

CONSTRUCTION		UTILITIES	TENANT SERVICES
Foundation	Concrete	Public Water Supply, Gas, Electricity and Sanitary Sewer	Heat, Hot and Cold Water, Gas, Electricity, Refuse Removal, Customary Maintenance, Air Conditioning, Master TV Antenna, Swimming Pool, Playground and On-site Parking
Ext. Walls	Brick and Frame		
Floors	Linoleum and Vinyl Tile		
Roofing	Asphalt Shingles		
Heating	Individual - Electric	PAVING: Macadam Streets and Parking Lot; Concrete Curbs Sidewalks	EQUIPMENT: Electric Ranges and Refrigerators, Drapes, Carpeting, Disposals, Dishwashers, Kitchen and Bath Exhaust Fans
Air Conditioning	Individual - Electric		
Dom. Hot Water	Central - Gas		
Basement	None		

CURRENT RENTALS

No. Units	Type	Monthly Rate
12	1 BR	$185
68	2 BR - 1½ B	$215
40	3 BR (1 full bath, 2 half baths)	$260
Gross Annual Rent Roll		$326,880

APPROXIMATE EXPENSES

Type	Amount
Taxes Per Yr.	(1) $36,136.97
Res. for Repl. Per Annum	$12,000.00

OCCUPANCY PERCENTAGE

Year	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1975							94	94	95	96	96	98
1976	97	98	98	98								

(1) 1974/75 Real Estate Taxes: State & County $7,723.05; City $14,188.20; School $14,225.72

NOTE: All tenants are on month-to-month leases.
HUD's estimate of the total annual cost of operation, maintenance, taxes and reserve for replacements is $199,037.
Each unit is equipped with washer and dryer connections.

PROJECT BOOKS AND RECORDS WILL BE AVAILABLE FOR INSPECTION BY PROSPECTIVE BIDDERS AT THE PROJECT SITE.

Purchaser will be required to execute a Regulatory Agreement with the Secretary of Housing and Urban Development. Copy of the Agreement will be supplied with the bidding instructions. It provides, inter alia, that all charges for occupancy of dwelling accommodations and for the provision to tenants of facilities and/or services must be approved in writing by the Secretary; and that the use of and charges for commercial space must be approved by the Secretary.

GENERAL INFORMATION

Fire and Extended Coverage will be required at closing in an amount so as to each coverage not less than necessary to comply with the applicable co-insurance percentage, but in no event less than 80% of the Insurable Values or not less than the unpaid balance of the mortgage, whichever is the lesser, issued by insurers satisfactory to the Secretary, together with receipted invoice evidencing payment of the premium charges for not less than 12 months in advance.

Purchaser will be required to accept the property WITHOUT WARRANTY AS TO PHYSICAL CONDITION.

Title to all equipment and chattels owned and used by the Secretary in the operation of the property will pass to the purchaser, but WITHOUT WARRANTY AS TO PRECISE COUNT AND CONDITION.

While care has been exercised to assure accuracy, all information provided is solely for the purpose of permitting parties to determine whether or not the property is of such type and general character as might interest them in its purchase, AND HUD MAKES NO WARRANTY AS TO THE ACCURACY OF SUCH INFORMATION. Those interested are expected to acquaint themselves with the property, and to arrive at their own conclusions as to physical condition, number and occupancy of revenue producing units, estimates of operating costs, and any factors bearing upon valuation of the property. Project books and records will be available for inspection by prospective bidders at the project site.

DEPOSIT WITH BID. Bids must be accompanied by Money Order, Certified, Cashier's or other banker's check to U. S. Department of Housing and Urban Development for not less than the REQUIRED DEPOSIT, to be applied on the purchase or returned if the bid is rejected.

TERMS OF SALE. The Secretary will accept mortgage securing note in the MAXIMUM MORTGAGE AMOUNT given by the purchaser to be amortized by the LEVEL ANNUITY METHOD in 480 monthly payments at 8½% interest, plus a service charge of ½ of 1%. The Purchaser must execute a standard Regulatory Agreement providing for the customary controls, including rents. The formula for the determination of the Maximum Permissive Rents is made a part of the Bidding Instructions. The sales contract, used as the bid form, is binding on acceptance by the Secretary and requires closing within 60 days. Following conveyance, the local HUD office will give consideration to the purchaser's request to convey the property to a nonprofit cooperative housing corporation with the corporation assuming the purchaser's obligations under the note and mortgage provided the nonprofit cooperative housing corporation can legally be formed in the jurisdiction where the project is located. The right is reserved to reject any or all bids and to waive any informality in any bid. If an acceptable bid pursuant to this advertisement is not received on the RETURN DATE in any instance, the Secretary will consider the first bid meeting the requirements specified herein if received within 90 days following the bid opening date as indicated herein. MONTHLY PAYMENT TO PRINCIPAL AND INTEREST IS $7.330941 PER $1,000 OF MORTGAGE REQUESTED.

INSPECTION OF PROPERTY

Prospective bidders are urged and invited to inspect the property. Inspections may be arranged Monday through Friday, between 9:00 A.M. and 4:00 P.M. local time by contacting either of the below:

PROJECT MANAGER

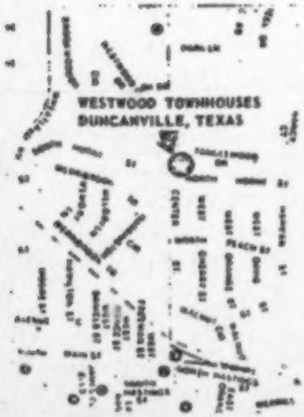
Coldwell Banker
3030 North Stemmons Freeway
Dallas, Texas 75247

AREA OFFICE

Multifamily Property Disposition Branch
Sidney Miller, Chief
2001 Bryan Tower, 4th Floor
Dallas, Texas 75201
Telephone 214-749-3372

BIDDING INSTRUCTIONS
MUST BE OBTAINED FROM

U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
HOUSING MANAGEMENT
OFFICE OF PROPERTY DISPOSITION
ROOM 9264
WASHINGTON, D. C. 20410



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GENTLEMEN:

I am interested in submitting a bid on this property. Please send a Bidder's Kit and instructions for submitting a bid. My address is listed below.

NAME ______________________________
(Please Print or Type)

ADDRESS ______________________________

CITY ______________ STATE ________ ZIP CODE ________

THANK YOU

____

WESTWOOD TOWNHOUSES, DUNCANVILLE, TEXAS
PROJECT NO. 113-35124

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OFFICE OF PROPERTY DISPOSITION
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Washington, D. C. 20410

Supreme Court of the United States

No. 81-1536

Commissioner of Internal Revenue, petitioner,

v.

John F. Tufts, et al.

Order Allowing Certiorari. Filed May 3, 1982

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1982 375613 1003

Opposition

81-1536

Supreme Court, U.S.
FILED
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No.

IN THE

Supreme Court of The United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

JOHN F. TUFTS AND MARY A. TUFTS, ET AL.,
Respondents

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Respondents respectfully submit that this Court should affirmatively exercise its judicial discretion in declining to review the decision of the Fifth Circuit Court of Appeals. Resolution of the issue presented in this case is more properly the subject of legislative, as opposed to judicial, action.

A. SUMMARY OF ARGUMENT:

Correction of an "aberrational result" (Pet. Br. at 18) in the application of tax laws to income or loss does not warrant judicial legislation by this Court. Rather, Petitioner should seek remedial action in Congress, as was done to avoid the unforeseen effect of the "cost basis" holding *of Crane v. Commissioner*[1] in tax shelter situations.

B. ARGUMENT:

1. Petitioner's Ground For Review By This Court, The Realization Of A Tax Loss, Does Not Warrant Judicial Legislation.

Petitioner states that, "in sum", if the decision of the Fifth Circuit is permitted to stand, a "decline in value of property burdened by non-recourse indebtedness will produce a tax loss to the owner even though the economic loss associated with the decline in value is borne entirely by someone else . . ." Pet. Br. at 18. This result is described by Petitioner as an "aberration" which calls for review by this Court. *Id.*

Respondents respectfully submit that the result perceived by Petitioner is more clearly a matter of legislative, rather than judicial, concern. Whether a tax loss should be deductible upon the disposition of property subject to a nonrecourse debt is a policy question calling for legislative action. When Petitioner perceived another problem arising out of *Crane,* basis without liability, he went to Congress for a solution. Congress did restrict tax losses resulting from the inclusion of non-recourse debt in cost basis by the enactment of "at risk" rules, first in Section 704(d) and then in Section 465.[2] The same type of legislative review and, if appropriate, response should be applied to the Petitioner's concern that a deductible tax loss might result from the disposition of property which has declined in value and is subject to a non-recourse debt.

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[1] *Crane v. Commissioner*, 331 U.S. 1 (1941) (hereinafter referred to as "*Crane*").

[2] All statutory references are to the Internal Revenue Code of 1954 as amended (hereinafter, "the Code").

2. The Real Issue is Whether the Code's Definition of "Amount Realized" Should be Amended; a Matter for Legislative Action.

Section 1001(b) of the Code defines "amount realized". The relevant portion of that section reads as follows:

> (b) Amount Realized — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

The Code's definition of "cost basis" is even simpler:

> "Section 1012. Basis of Property — Cost. The basis of property shall be the cost of such property . . ."

Petitioner seeks judicial amendment to establish a "functional relation" between these two statutory terms.[3]

Forty-one years ago, *Crane* ruled that the statutory term "cost" included an amount which, although not a personal debt of the property owner, was secured by and to be repaid out of her property. Similarly, the term "amount realized" was defined as including the "satisfaction" of such an amount if it would be paid out of the property, just as if such amount was a "recourse debt".

Neither of these statutory definitions have been legislatively amended over the past 41 years; nevertheless, it has been assumed that this Court's decision in *Crane* modified each so that non-recourse mortgage debt usually could be included in cost basis[4] and in the "amount realized" on a property's disposition.[5]

---

[3] Petitioner's 1980 attempt to amend Section 1001(b) in Treas. Reg. § 1.1001-2(b) to achieve that result does not have Congressional mandate and, therefore, represents only an "interpretation".

3. Judicial Restraint: Crane Limited Itself to Its Own Facts.

The *Crane* opinion explained in some detail the economic rationale for its "amount realized" conclusion: *That non-recourse debt fully secured by property would be treated by the property's owner as though it were recourse debt.*

The Court went on to *limit expressly* the application of its holding to situations in which that economic rationale was justified: *Where the property involved has a value at least as high as the mortgage.* Otherwise, the Court explained in Footnote 37, the reason for its conclusion, economic benefit to the property owner, might not be present.

4. Taxpayer's Exploitation of the "Cost Basis" Aspect of Crane Was Met By Legislative Amendment.

Tax planners realized quickly that the "cost basis" aspect of *Crane* had significant possibilities. If a taxpayer could treat non-recourse debt as cost basis for depreciation purposes, he could deduct amounts he might never actually be required to pay. In fact, an entire national housing program based on FHA guarantees of non-recourse debt was designed and implemented in reliance on this concept.

---

[4] But not always: value makes a difference. Petitioner has successfully refuted this conclusion in the courts where the fair market value of the acquired property was determined to be much lower than its stated purchase price. *See, Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Edward B. Hager*, 76 T.C. 759 (1981); *David L. Narver*, 75 T.C. 53 (1980).

[5] Section 752(c) creates a similar "fair market value" limitation in partnership situations involving contributions, distributions and sales.

When the Treasury decided that the tax advantages resulting from *Crane's* inclusion of non-recourse financing in cost basis were abusive, it sent to Congress and secured the enactment of an "at risk" provision which limited *Crane's* effect on "deductible cost basis" to real estate investors. Others were denied the tax advantages of "cost basis" unless they were "at risk" for its economic burden.[6] Congress apparently felt that real estate investors should continue to enjoy the benefits of nonrecourse financing without losing any related tax benefits, a proper subject of legislative discrimination.

5. Petitioner Has Broadly Applied the "Amount Realized" Side of Crane.

Petitioner has relied upon *Crane* as authority to tax virtually all dispositions of mortgaged property.[7] This result may have been consistent with *Crane's* economic analysis of benefit to the taxpayer as long as inflation insured that property values were higher than mortgage balances upon disposition. The instant case, however, arose during a real estate recession in which the value of the property was less than the mortgage balance.

Petitioner now attempts to use *Crane* as authority to "match" cost basis with "amount realized" and thus require the "recapture" of deductions properly taken by the property owner.[8] While this approach may be effective tax administration, it represents outright legislation,[9] which should not be sanctioned by our courts. If the Constitution permits an income tax to be levied on the disposition of a loss venture which produces no recompense or economic recovery to the taxpayer, such a tax should be enacted by Congress, not this Court.

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[6] Section 465. The "at risk" element of Section 704(d) was repealed for years after 1978.

[7] For example, in recent cases Petitioner has been successful in having the *Crane* definition of "amount realized" applied so as to tax "net gifts" (subject to donee's payment of the gift tax), *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981) and to tax a charitable contribution of mortgaged realty, *Winston F. C. Guest*, 77 T.C. 9 (1981). These cases involved property having a value in excess of the "debt" (tax or mortgage) and relied on economic benefit to justify a tax.

6. The Court Should Decline Petitioner's Invitation To Legislate.[10]

Respondents respectfully submit that this Court should decline Petitioner's invitation to correct through judicial legislation the perceived result of the lower court's decision. Petitioner urges this Court's review for the reason that an improper tax loss may be made available to a taxpayer upon disposition of non-recourse mortgaged property that has declined in value. (Pet. Br. 18) Petitioner has been thwarted by the Court below in his attempt to apply *Crane* to tax Respondent's loss venture as though it had produced profit. Respondents submit that if Petitioner believes these are inappropriate results, he should seek remedial action through Congress,[11] which has demonstrated the will and means to deal effectively with tax shelters[12] and other tax matters about which the courts could not agree.[13]

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[8] Existing "depreciation recapture" provisions of the Code do not purport to create "amount realized" where none exists, but only to characterize actual income as ordinary rather than capital gain. Sections 1245 and 1250.

[9] The Commissioner was successful in achieving such a policy decision in *United States v. Hendler*, 303 U.S. 564 (1938) and then "corrected" its victory in Congress when the total import of the Court's conclusion was perceived. Legislation should come from legislatures. *See*, Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 Yale L. J. 1 (1940); Bittker and Eustice, "Federal Income Taxation of Corporations and Shareholders", § 3.07 (4th edition 1979).

[10] Attorney General French-Smith so suggested in a number of recent speeches. Eg. Dec. 2, 1981 before National Association of Attorneys General, New Orleans, Louisiana; Jan. 25, 1982 before House of Delegates, American Bar Association, Chicago, Illinois.

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[11] "If Congress wants a better job done, Congress should provide a tool that will not just plug the loophole 'a substantial part of the way.'" *Commissioner v. Kelley*, 293 F.2d 904, 911 (5th Cir. 1961).

[12] For example in 1981 "tax straddles" were met by massive defensive legislation before any court passed on their validity. Section 1092.

[13] For example, Section 453 was amended by the Installment Sales Revision Act of 1980 to resolve a conflict between the Tax Court and the Tenth Circuit Court of Appeals as to whether letters of credit represented "payment". S. Rept. No. 96-1000, 96th Cong. 2d Sess. 1980.

CONCLUSION

The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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No. 81-1536

In the Supreme Court of the United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS and MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether, for purposes of computing gain or loss for tax purposes, a person who owns property subject to mortgage indebtedness for which he assumes no personal liability (nonrecourse debt) and who properly includes the funds borrowed under the mortgage in his cost basis of the property for depreciation and other purposes, must likewise include the full measure of the unrepaid indebtedness as an "amount realized" when he disposes of the property subject to the mortgage, whatever the fair market value of the property at the time of disposition.

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In the Supreme Court of the United States

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v.

JOHN F. TUFTS and MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 1a-21a) is reported at 70 T.C. 756. The opinion of the court of appeals (Pet. App. 22a-40a) is reported at 651 F.2d 1058.

JURISDICTION

The judgment of the court of appeals was entered on July 27, 1981. The court of appeals denied a petition for rehearing, with suggestion for rehearing en banc, filed on behalf of the Commissioner of Internal Revenue on October 19, 1981 (Pet. App. 41a-42a).[1] By order dated January 4, 1982, Justice White extended the time within which the Commissioner could file a petition for a writ of certiorari to and including February 16, 1982, and the petition was filed on that date. The petition was granted on May 3, 1982 (J.A. 31). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

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[1] The Commissioner's petition for rehearing en banc was supported by a Memorandum Amicus Curiae signed by 30 private practitioners and law professors, including two former Commissioners of Internal Revenue, and former Treasury officials. For the convenience of the Court, we are lodging with the Clerk a copy of the Memorandum and the motion for leave to file it.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 752, 1001, 1011, 1012, and 1016 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in Pet. App. 43a-46a. Section 1.1001-2 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) is set forth at App., *infra*, 1a-6a.

STATEMENT

A. The Facts of this Case

1. *The Formation and Operation of the Partnership.* On August 1, 1970, respondents J.C. Pelt and Clark, Inc., Pelt's wholly-owned corporation, entered into a general partnership agreement for the purpose of constructing a 120-unit apartment complex in Duncanville, Texas, a suburb of Dallas (Pet. App. 2a; J.A. 13; Exh. 7-G). Six days later, the partnership obtained a commitment from the Farm & Home Savings Association for a $1,851,500 loan for construction of the complex. Under the terms of the note and deed of trust executed in favor of the lender, neither the partnership nor the partners assumed personal liability for the payment of this loan. Rather, the creditor's interest was protected solely by a security interest in the property. Hence, the liability of the partnership and the partners was nonrecourse in nature (J.A. 13; Pet. App. 3a-4a; Exhs. 8-H, 9-I, 10-J).[2]

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[2] While the lending institution had no recourse against the partners personally, it was protected against loss by government-sponsored mortgage insurance. Pursuant to the National Housing Act, 12 U.S.C. 1715*l*(b) and 1715*l*(d)(4), which was enacted to encourage the construction of housing for low and moderate-income families, the apartment complex to be built by the partnership was endorsed for mortgage insurance by the Secretary of Housing and Urban Development (HUD) (Pet. App. 3a). Thus, the federal government, through HUD, guaranteed the payment of the $1,851,500 nonrecourse mortgage secured by the partnership.

On August 21, 1970, respondents[3] John F. Tufts, William T. Steger, James E. Stephens, and Robert C. Austin, Sr., friends and relatives of Pelt, were admitted as additional general partners (Pet. App. 4a; J.A. 14; Exh. 11-K).

Construction of the apartment complex began shortly after the partnership obtained financing for the project, and the complex was completed about a year later (Pet. App. 4a).[4] Even though none of the partners had contributed any property to the partnership, each respondent included his proportionate share of the $1,851,500 nonrecourse indebtedness in computing his tax cost basis in his partnership interest,[5] against which he claimed a pass-through of depreciation and other deductions attributable to the partnership operation (Pet. App. 4a-5a). 26 U.S.C. 705(a), 722 and 752(a).[6]

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[3] Although we employ the terms "respondents" and "partners" interchangeably to refer to the general partners, the term "respondents" also includes the partners' wives, who are parties to this proceeding solely because they filed joint returns with their husbands for the year at issue.

[4] Although Pelt testified that the entire amount of the loan proceeds ($1,851,500) was spent in building the apartment complex (J.A. 25-26), the partnership's tax returns for 1971 and 1972 reflect a total cost basis for the complex of only $1,634,411 (Pet. App. 3a; Exhs. 25-Y, 26-Z). As the Tax Court noted, "[t]he disposition of the remainder of the loan proceeds [$217,089] is unclear" (Pet. App. 3a n.5).

[5] A partner's basis in his partnership interest is important for tax purposes. Under the statute, basis serves as a measure against which a partner can deduct his distributive share of partnership losses (deductions) (26 U.S.C. 704(e)). In general, a partner's basis in his partnership interest equals the amount that the partner has paid for that interest (either paid to another or contributed to the partnership) (26 U.S.C. 742 and 722). A partner is given credit for his share of partnership liabilities in determining what he has paid for his interest (26 U.S.C. 752(a) and 722).

[6] Each partner's adjusted basis in his partnership interest on August 21, 1970, was as follows (J.A. 14; Pet. App. 4a-5a):

In the years following the formation of the partnership, the partners made various cash contributions to it, which resulted in corresponding increases in the bases of their respective partnership interests (26 U.S.C. 722) (Pet. App. 5a; J.A. 15, 17). During 1971 and 1972, they paid the following amounts into the partnership:

Partner	1971	1972	Total
Pelt	$21,439	$15,861	$37,300
Clark, Inc.	308	—	308
Tufts	2,771	—	2,771
Steger	2,771	—	2,771
Stephens	231	—	231
Austin	831	—	831

During the three years in which the partnership owned the apartment complex, the partners claimed on their respective individual income tax returns approximately $400,000 in tax deductions attributable to their partnership activities (J.A. 14-17; Pet. App. 5a-6a). Because their bases in the partnership interests were attributable in large measure to the nonrecourse debt, respondents' deductions were well in excess of the amounts they had actually contributed (Pet. App. 23a).[7]

Partner	Percentage Ownership	Adjusted Basis
Pelt	25	$ 462,875.00
Clark, Inc.	10	185,150.00
Tufts	25	462,875.00
Steger	25	462,875.00
Stephens	7.5	138,862.50
Austin	7.5	138,862.50
		$1,851,500.00

[7] The deductions were as follows:

Partner	Type of Deduction	1970	1971	1972	Total
Pelt	Ordinary Loss	$21,946	$40,409	$20,629	$ 82,984
	Depreciation	—	15,430	11,578	27,008
					$109,992

Respondents' total cash contributions to the partnership and claimed tax deductions from their partnership activities were as follows (Pet. App. 5a-6a):

Partner	Total Cash Contributions	Total Tax Deductions
Pelt	$37,300	$109,992
Clark, Inc.	308	43,995
Tufts	2,771	109,992
Steger	2,771	109,992
Stephens	231	32,996
Austin	831	32,996
	$44,212	$439,963

2. *The Partnership's Sale of the Project.* As a result of adverse economic conditions in the Duncanville area, the rental income generated by the apartment complex was less than anticipated. Accordingly, the partners were unable to reduce any of the principal of the mortgage debt. Thereafter, on August 28, 1972, when the fair

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Partner	Type of Deduction	1970	1971	1972	Total
Clark, Inc.	Ordinary Loss	8,779	16,163	8,251	33,193
	Depreciation	—	6,171	4,631	10,802
					43,995
Tufts	Ordinary Loss	21,946	40,409	20,629	82,984
	Depreciation	—	15,430	11,578	27,008
					109,992
Steger	Ordinary Loss	21,946	40,409	20,629	82,984
	Depreciation	—	15,430	11,578	27,008
					109,992
Stephens	Ordinary Loss	6,584	12,122	6,188	24,894
	Depreciation	—	4,629	3,473	8,102
					32,996
Austin	Ordinary Loss	6,584	12,122	6,188	24,894
	Depreciation	—	4,629	3,473	8,102
					32,996

market value of the complex had declined to approximately \$1.4 million,[8] each partner sold his partnership interest to Fred Bayles, an unrelated third party (Pet. App. 7a; Exhs. 27-BA, 28-BB, 29-BC, 30-BD, 31-BE, 32-BF, 33-BG).[9] Respondents, however, did not sell their partnership interests for cash. Rather, Bayles agreed to take the property subject to the outstanding mortgage. Thus, according to the agreement of sale, Bayles paid no consideration to any of the partners, except for the direct expenses of the sale, up to \$250, and he acquired the apartment complex subject to the nonrecourse mortgage liability of \$1,851,500 (Pet. App. 6a-7a). At the time of the sale, the total adjusted basis of all of the partners' interests in the partnership had been reduced from \$1.85 million to approximately \$1.45 million, as follows (J.A. 18; Pet. App. 6a):

Partner	Adjusted Basis[10]
Pelt	\$ 390,182
Clark, Inc.	141,461
Tufts	355,653
Steger	355,653
Stephens	106,095
Austin	106,695
	\$1,455,739

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[8] The Commissioner contended at trial that the fair market value of the apartment complex at the time of sale was \$1,851,500, the unpaid principal amount of the mortgage. The Tax Court, however, determined that the value of the complex at the time of sale did not exceed \$1,400,000 (Pet. App. 10a). The Commissioner did not challenge this factual determination in the court of appeals.

[9] On the same date, each partner also conveyed all of his right, title and interest in the partnership property to Bayles (Pet. App. 7a).

[10] The adjusted basis figures are computed by adding each partner's cash contribution to his original basis in the partnership (*i.e.*, his respective share of the nonrecourse liability), and subtracting from that sum the losses and depreciation claimed by each of the partners on his income tax returns.

Hence, under the sales agreement, respondents sold their partnership interests in which they had a collective tax basis of $1,455,739, for a nominal cash payment, but subject to the mortgage obligation of $1,851,500.[11] Respondents, however, did not view their sales transaction as producing gain measured by the difference ($395,761) between their total basis and an amount realized equal to the outstanding mortgage liability burdening the transferred interests. Instead, on their income tax returns for 1972, respondents took the opposite position and reported that they had suffered a loss on the sale of their partnership interests, measured by the $55,739 difference between their total adjusted tax basis ($1,455,739) and the fair market value of the property (their partnership interests) at the time of the sale ($1,400,000). Although they characterized the sale as producing a loss on their tax returns, the partners did not then claim any deduction for that alleged loss (J.A. 21).

On audit, the Commissioner of Internal Revenue determined that the partners were liable in the aggregate for taxes on approximately $400,000 in capital gain, equal to the difference between their total basis in the partnership and the mortgage liability to which the partnership property was subject. The Commissioner's determination rested on the ground that the "amount realized" on the disposition of their partnership interests was the full face amount of the nonrecourse loan to which the property was subject (approximately $1.85 million) when Bayles took over the property (Pet. App. 7a-9a, 23a-24a).

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[11] Bayles operated the apartment complex for several years, but the income generated by the complex was not sufficient to cover its operating expenses and mortgage debt, and in 1974 the lender foreclosed on the property (J.A. 26). HUD, which had insured the $1,851,500 mortgage debt, obtained title to the apartment complex upon payment of the insurance proceeds to the lender. On September 28, 1976, HUD sold the complex to another real estate developer, Irwin R. Rose (Tr. 66; J.A. 21-22; Exh. BI). We are advised by HUD that the apartment complex was sold to Rose for $1,502,000, financed in part by a $1,314,800 nonrecourse mortgage (Exh. BI). Thus, up to that point, the federal government sustained a loss of $349,500 ($1,851,500 less $1,502,000) in connection with the apartment complex at issue in this case.

B. The Proceedings Below

Respondents thereafter commenced this proceeding in the Tax Court for redetermination of the deficiencies determined by the Commissioner. In the Tax Court, respondents disavowed the position they asserted on their returns with respect to the sales transaction. In their petitions in the Tax Court, respondents turned about and claimed a deduction for a long-term capital loss on the sale of their partnership interests equal to the difference between their adjusted basis in the partnership ($1,455,739) and the fair market value ($1,400,000) of the partnership property. They took "the position that the [Tax] Court should review and decide whether in fact this loss should be allowed" (J.A. 21).

The Tax Court rejected respondents' claimed loss and upheld the Commissioner's determination that they had realized a gain on the sale (Pet. App. 7a-21a).[12] It ruled that because respondents properly took the total nonrecourse liability of the partnership into account in computing their bases and the tax deductions claimed with respect to their partnership interests, the total amount of the liability had to be likewise included in the "amount realized" when the partnership interests were sold and the partnership's property was transferred subject to the

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[12] The Tax Court ultimately found income tax deficiencies in the following amounts:

Respondent	Taxable Year	Income Tax Deficiency
Pelt	1972	$ 2,707.00
Clark, Inc.	8-1-72 through 7-31-73	12,729.68
Tufts	1972	30,398.75
Steger	1972	30,405.00
Stephens	1972	3,360.89
Austin	1972	6,683.49

encumbrance. In the Tax Court's view, the inclusion of the liability in the "amount realized" was required regardless of the property's fair market value at that time.

In so holding, the Tax Court followed its prior decision in *Millar* v. *Commissioner*, 67 T.C. 656, 660 (1977), aff'd on this issue, 577 F.2d 212 (3d Cir.), cert. denied, 439 U.S. 1046 (1978), which, on virtually identical facts, rejected respondents' argument that the nonrecourse debt was not includable in the "amount realized" where the value of the property was less than the liability. The court reasoned that any contrary conclusion "would be totally inconsistent with the rationale for the holding of [*Crane* v. *Commissioner*, 331 U.S. 1 (1947)] * * *. [S]ince the total liability has been taken into consideration in determining other tax consequences of the transaction, the total liability must also be included in the amount realized when the property is transferred" (Pet. App. 14a).

The court of appeals reversed (Pet. App. 22a-40a). Expressing "serious reservations" (*id.* at 32a) as to the correctness of this Court's decision in *Crane* and believing that the theory upon which *Crane* was decided is "seriously flawed" (*id.* at 30a), the court of appeals declined to apply the rationale of *Crane* beyond the precise facts of that case. It held that nonrecourse debt is includable in the amount realized upon the disposition of property subject to nonrecourse indebtedness only to the extent of the fair market value of the property securing the debt. Despite the contrary conclusion of this Court in *Crane*, the court below concluded that there was "no relationship between basis, adjustments to basis, and amount realized" (Pet. App. 35a n.9). It therefore held that the only amount respondents realized upon the sale of their partnership interests subject to the nonrecourse debt was the fair market value of the property securing the debt.[13]

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[13] Judge Williams concurred in the result (Pet. App. 35a-40a). In his view Section 1001(b) of the Internal Revenue Code of 1954, which

SUMMARY OF ARGUMENT

1. Under Section 1001 of the Internal Revenue Code of 1954, gain from the disposition of property is measured by the difference between the "amount realized" from the property and the taxpayer's "adjusted basis" in the property. Generally, the amount realized is the amount received on disposition of the property. A taxpayer's adjusted basis in property, in turn, is his cost, as adjusted upward to reflect additional investments in the property, and as adjusted downward to reflect the depreciation, depletion, and other deductions allocable to the property during the taxpayer's ownership.

In the normal case, a taxpayer's cost basis in property for tax purposes is not confined to his out-of-pocket expenditures related to acquisition of the property. Rather, tax basis generally includes all amounts paid and all purchase-money liabilities undertaken with respect to the acquired property. In turn, the amount realized upon the disposition of property generally includes debts discharged by the transfer or transferred with the property. Thus, if A purchases property for $25,000 in cash and obtains a $75,000 mortgage loan, his basis in the property is $100,000. If he later sells it for $35,000 plus the seller's agreement to assume the unamortized mortgage balance of $75,000, the amount realized is $110,000 ($35,000 plus

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defines amount realized as "the sum of any money received plus the fair market value of the property (other than money) received," required a decision for respondents. Concluding that respondents' release from the nonrecourse debt constituted property other than money, Judge Williams determined that "the fair market value of the release corresponds directly to the fair market value of the property securing the nonrecourse indebtedness" (Pet. App. 39a). He therefore concluded that the amount realized by the taxpayers when they sold the property was limited to $1.4 million, the property's fair market value at the time. Recognizing that this result "produces grave consequences for the equitable administration of the tax code" (*id.* at 40a), Judge Williams called for a "retool[ing of] the code mechanism" for policing exaggerated depreciation and loss deduction claims grounded on a basis inflated by nonrecourse borrowing (*ibid.*).

$75,000), resulting in a $10,000 gain. Moreover, a taxpayer's basis does not turn on whether he is personally liable on the indebtedness encumbering the property, or whether the debt is nonrecourse in nature. In either event, the debt is includable in his cost basis and any amount remaining unpaid is includable in the amount realized upon disposition to a person taking the property subject to the mortgage.

2. The foregoing principles have been established at least since this Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947). There, the Court concluded that relief from the obligation of a nonrecourse mortgage upon the sale of the encumbered property for cash plus the buyer's taking subject to the mortgage was includable in amount realized. Upon such a transfer, "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another" (*id.* at 14). In so holding, the Court recognized the "functional relation" in the statute between basis and amount realized.

Here, respondents' partnership invested approximately $40,000 in cash in an apartment complex and financed the remainder of the project with a $1.85 million nonrecourse loan. At the time respondents received the proceeds of the $1.85 million loan and invested it in the project, they properly excluded it from their gross income because of their obligation to repay the loan. They also included the loan in their basis in their partnership interests. Just as the exclusion of borrowing from a debtor's gross income is premised upon the existence of a corresponding obligation to repay the debt, the inclusion of borrowed funds in the cost basis of debt-financed property proceeds upon the identical assumption that the owner of the property will pay off the debt encumbering the property. If, as here, that assumption proves false because the taxpayer-owner of the property disposes of it subject to the mortgage, the taxpayer is required to account for this fact by including the unrepaid mortgage indebtedness in the amount realized.

In the present case, this principle requires respondents to include the full $1.85 million in their "amount realized." The disposition of their partnership interests subject to the mortgage demonstrates with certainty that they will never repay the mortgage loan. Thus, if the $1.85 million is not included in their amount realized, they will have received funds whose tax-free receipt was predicated only on the assumption that the loan would be fully repaid. As a consequence, respondents will never have to account for the benefits they undeniably derived from the $1.85 million loan. Nothing in the Code calls for such a bizarre result. Indeed, the fundamental teaching of this Court in *Crane* rejects it.

The decision below, however, adopted precisely that result. It held that the "amount realized" by respondents on their sale of their partnership interests subject to the nonrecourse mortgage was limited to the $1.4 million value of the property. But the fair market value of the property has no bearing on the computation of the "amount realized" in such a case. Respondents have discharged a $1.85 million debt by transferring property worth $1.4 million. They certainly have not suffered a $400,000 economic loss as a result of the decline in value of the property. They received a $1.85 million nonrecourse loan which they did not take into income. That loan enabled respondents to purchase basis and claim approximately $400,000 ($440,000 in deductions less their cash investment of $40,000) in tax deductions associated with their partnership activities.

If, as the decision below held, only $1.4 million of the nonrecourse mortgage is included in the amount realized on the sale of the property, respondents will never have to account for the $400,000 in tax-free income realized from their investment. Logic, and the statute's directive to tax all income "from whatever source derived," demand that if nonrecourse borrowed funds received tax free can confer basis and the resultant tax deductions, then the unrepaid amount of such indebtedness must be included in the amount realized upon the disposition of the property subject to the mortgage.

3. The reservation expressed by the Court in footnote 37 of its opinion in *Crane*, upon which the court of appeals seized, does not constitute authority for the ruling below that, when the value of the property is less than the amount of the mortgage, the amount realized upon sale for tax purposes must be limited to the value of property. Properly read, the statement in footnote 37 simply reflects the Court's view that the economic benefit aspect of its analysis in that case, equating a nonrecourse mortgage with a personal obligation, does not necessarily apply where the value of the property is less than the nonrecourse mortgage. Indeed, until the decision below, the lower courts consistently interpreted *Crane* to require the inclusion of the full amount of the nonrecourse debt in amount realized, regardless of the value of the property upon disposition. The exception to the *Crane* rule adopted by the court of appeals is an anomaly that should not be permitted to stand.

ARGUMENT

THE PROPER COMPUTATION OF GAIN OR LOSS UPON THE DISPOSITION OF PROPERTY REQUIRES THAT UNREPAID FUNDS BORROWED UNDER A NONRECOURSE MORTGAGE TO PURCHASE PROPERTY AND INCLUDED IN THE COST BASIS OF SUCH PROPERTY FOR TAX PURPOSES MUST LIKEWISE BE INCLUDED IN THE "AMOUNT REALIZED" FROM THE DISPOSITION OF THE PROPERTY SUBJECT TO THE MORTGAGE, REGARDLESS OF THE FAIR MARKET VALUE OF THE PROPERTY AT THE TIME OF DISPOSITION

The court below ruled that the "amount realized" by respondents on the sale of their partnership interests was limited to the property's fair market value at the time of sale ($1.4 million) despite the fact that their interests were transferred subject to a debt well in excess of that amount ($1.85 million). The decision below thus upheld respondents' claim to a loss based upon a cost they never incurred and never would incur, *i.e.*, the extent to which their $1.85 million nonrecourse liability exceeded the $1.4 million fair market value of their partnership interests. Put in terms of the pertinent figures, the court of appeals allowed respondents to claim a further tax loss of $55,739, in addition to their previously-claimed deductions of $439,963, from an investment in which their cash contributions were limited to $44,912. It is our submission that, properly interpreted, the Internal Revenue Code does not countenance such a result.

A. The Proceeds of a Loan Are Not Income to the Borrower; Hence, Repayment of Less Than The Amount Borrowed Normally Results in Income to the Borrower

1. This case presents an important question that goes to the heart of the federal income tax treatment of the sale or other disposition of debt-financed property. While specific Code provisions are at issue and the particular focus of this case is upon this Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), the case should also be considered in the context of more fundamental principles of our system of income taxation.

It is well recognized that the receipt of loan proceeds does not constitute gross income. Section 61(a) of the Internal Revenue Code of 1954 defines "gross income" as "all income from whatever source derived, including (but not limited to) * * *" 15 illustrative items. If A extends a $100 bona fide loan to B, does B have income of $100? While Section 61(a) might be expansively construed to support the hypothesis that the $100 is income to B, we know instinctively that such is not the case. But what is the basis of our instinctive, and perfectly sound, resistance to charging a borrower with income in the amount of his loan? It is, we submit, the existence of a corresponding obligation to repay the loan. The characteristic of a loan that excludes it from gross income is "the consensual recognition, express or implied, of an obligation to repay * * *." *James* v. *United States*, 366 U.S. 213, 219 (1961).

To put the matter in the accounting terminology of a balance sheet, the economic benefit of $100 received by B is matched by an offsetting liability to A in the same amount. As long as B recognizes his obligation to pay back the loan, the $100 is not income to him because there has been no unqualified "accession[] to wealth, clearly realized, and over which the taxpayer[] ha[s] complete dominion." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). See also *United States* v. *Rochelle*, 384 F.2d 748, 751 (5th Cir. 1967); 1 J. Mertens, *Law of Federal Income Taxation* § 5.12 (rev. 1974).

2. If the theoretical basis for excluding the proceeds of a loan from the gross income of the borrower is the existence of an offsetting liability to repay the loan, then the termination of that liability with the repayment in cash of less than the amount received should normally give rise to taxable income. The classic illustration of that principle is this Court's decision in *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931). There, the Court held that where a corporation purchased and retired some of its own bonds for less than their par value (which it had received for them when issued), the difference was taxable income. The taxable receipt arose upon the cancellation or discharge of the indebtedness when the corporation purchased its bonds for less than the liability they represented.[14]

The proposition that relief from a liability can be treated as consideration received on the disposition of property—*i.e.*, part of the "amount realized"—is squarely supported by *Crane* v. *Commissioner*, 331 U.S. 1 (1947), the decision that is the focus of this case. There, the Court concluded that relief from the obligation of a nonrecourse mortgage was part of the amount realized by the mortgagor upon the sale of the encumbered property for cash plus the buyer's taking subject to the mortgage. Upon such a transfer, "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." *Id.* at 14.

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[14] See also *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929); *United States* v. *Hendler*, 303 U.S. 564, 566 (1938); *Brons Hotels, Inc.* v. *Commissioner*, 34 B.T.A. 376 (1936); *Gillin* v. *United States*, 423 F.2d 309 (Ct. Cl. 1970); *Commissioner* v. *Stanley Co.*, 185 F.2d 979 (2d Cir. 1951); *Central Paper Co.* v. *Commissioner*, 158 F.2d 131 (6th Cir. 1946).

And only last Term in *Diedrich* v. *Commissioner*, No. 80-2204 (June 15, 1982), the Court, relying upon *Old Colony* and *Crane*, reaffirmed this principle in holding that a donor who makes a gift of property on the condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property. As the Court recognized, "[W]hen a donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an immediate economic benefit by the donee's assumption of the donor's legal obligation to pay the gift tax" (slip op. 6).

B. When Property is Used to Discharge a Debt in Full, the Amount Realized by the Debtor is the Amount of the Debt, Without Regard to the Value of the Property

1. A debt may be discharged in consideration of the transfer of property other than cash. When the value of the property equals the amount of debt discharged, there is no possibility from the lender's point of view that the borrower will have repaid less than he has borrowed. But the question is quite different from the borrower's point of view. He must address whether the amount of the debt discharged is greater or less than his adjusted basis in the property, thus giving rise to gain or loss on its disposition.

Under Section 1001(b) of the Internal Revenue Code of 1954, gain from the disposition of property is measured by the excess of the "amount realized" from such disposition over the taxpayer's "adjusted basis" in the property. Section 1001(b) defines the term "amount realized from the sale or other disposition of property" as "the sum of any money received plus the fair market value of the property (other than money) received."[15] A taxpayer's adjusted basis in purchased property, in turn, is his cost, as adjusted upward to reflect the additional investments in the property, and as adjusted downward to reflect the depreciation, depletion and other deductions allocable to the property during the taxpayer's ownership. Sections 1001(b), 1011(a), 1012 and 1016 (26 U.S.C.).

In the usual case,[16] a taxpayer's cost basis in property for tax purposes is not confined to out-of-pocket expendi-

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[15] Section 1001(b) of the Code of 1954 derives from Section 202(c) of the Revenue Act of 1924, 43 Stat. 256. The definition of "amount realized" has remained virtually unchanged since the original enactment. See Section 111(c) of the Revenue Act of 1928, 45 Stat. 816; Section 111(b) of the Revenue Act of 1932, 47 Stat. 196; and Section 111(b) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.).

[16] In some circumstances, the courts have held that certain excessive or ephemeral nonrecourse debts allegedly incurred in the acquisition of property are not properly includable in the purchaser's tax basis in the first instance. See, *e.g.*, *Gibson Products Co.* v. *United States*, 637 F.2d 1041 (5th Cir. 1981); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976). In *Gibson Products*, the court held that nonrecourse indebtedness exceeding the fair market value of the property securing the debt was not includable, to any extent, in the taxpayer's basis for the property. In that circumstance, the nonrecourse debt to which the property was subject would not be includable in the "amount realized" on the ultimate disposition of the property.

This result maintains the "functional relation" of basis and amount realized established by this Court in *Crane* (see pages 23, 27-28, *infra*). See Treasury Regulations on Income Tax (1954 Code), Section 1.1001-2(a)(3) (26 C.F.R.), providing that liabilities incurred "by reason of the acquisition of the property" need not be included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis for such property" (App., *infra*, 1a). Compare *Crane* v. *Commissioner*, *supra*, 331 U.S. at 15 n.42. However, there is no contention tures related to acquisition of the property. Thus, tax basis generally includes all amounts paid (whether from the taxpayer's own funds or from borrowed funds) and all bona fide liabilities undertaken with respect to the acquired property. This much has been accepted since at least this Court's decision in *Crane* v. *Commissioner*, *supra*, dealing with inherited property. Moreover, the lower courts have applied the *Crane* rule with respect to purchased property.[17]

2. Where property is used to discharge a debt, the amount of the debt discharged may be greater than the value of the property transferred. Where the proceeds of the loan represented by the debt are received tax free, and the creditor accepts the property in full satisfaction of the remaining debt, the debtor's taxable gain or loss on the property transferred is measured by including the full amount of the debt discharged as the consideration received. This situation occurs where, as here, property subject to a nonrecourse mortgage is transferred subject to the mortgage and the amount of the outstanding mortgage exceeds the value of the property.

The abuse that occurs if the full amount of the debt is not taken into account on the disposition of property is particularly apparent where, as here, borrowed funds are used to purchase property. Bona fide loans used to finance the purchase of property are generally treated

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that the nonrecourse indebtedness at issue here was excessive. Indeed, here the parties stipulated that respondents' basis in the property (through their partnership) included the nonrecourse debt (J.A. 18). Accordingly, respondents have been credited with a tax basis in their partnership interests equal to the full face amount of the nonrecourse mortgage they obtained when their partnership constructed the property.

[17] See, *e.g.*, *Teitelbaum* v. *Commissioner*, 346 F.2d 266, 269 (7th Cir. 1965); *Commissioner* v. *Fortee Properties, Inc.*, 211 F.2d 915, 916 (2d Cir. 1954); *Parker* v. *Delaney*, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951); *Blackstone Theatre Co.* v. *Commissioner*, 12 T.C. 801 (1949); *Mayerson* v. *Commissioner*, 47 T.C. 340, 352 (1966); *Brannen* v. *Commissioner*, 78 T.C. 471 (1982); *Siegel* v. *Commissioner*, 78 T.C. 659 (1982).

in the same manner as a taxpayer's own funds in determining his investment (cost basis) in purchased property. This treatment generally rests upon the same considerations that exclude borrowed funds from a borrower's income. That conclusion is no more than a necessary corollary to the rule permitting inclusion of that mortgage indebtedness in basis in the first instance. Just as the exclusion of borrowing from the debtor's gross income is premised upon the existence of a corresponding obligation to repay the debt, the inclusion of borrowed funds in the cost basis of debt-financed property likewise proceeds upon the identical assumption that the owner of the property will pay off the debt encumbering the property. If that assumption proves false because the owner of the property disposes of it subject to the mortgage, the elimination of indebtedness rule likewise fixes the day of reckoning upon which the taxpayer is required to close out the transaction and account for any potential income represented by his release from the unrepaid mortgage indebtedness. If this day of reckoning does not occur, the property owner will escape taxation forever on the amount of the unrepaid loan proceeds. The taxpayer will have received funds whose tax-free receipt was predicated only on the assumption that the loan would be fully repaid. Nothing in the Code calls for such a bizarre result. Indeed, the fundamental teaching of this Court in *Crane* rejects it.

The operation of the foregoing rules can be illustrated by the following example. If A purchases property for $100,000 by putting up $25,000 and obtaining a $75,000 fully recourse mortgage loan for which he is personally liable, his basis in the property is $100,000. The $100,000 is his cost, on the assumption that he will pay off the $75,000 loan in accordance with his undertaking. If he later sells the property for $35,000 cash plus the buyer's agreement to assume the unamortized mortgage balance of $75,000, the amount realized is $110,000 ($35,000 plus $75,000). In these circumstances, $100,000 turns out not to have been A's actual cost because, instead of repaying the loan, he has sold the property subject to the mortgage. We do not, however, reach back and adjust his basis downward in such a case, but rather account for his nonpayment of the loan by charging him with $75,000 of consideration received from the purchaser. Moreover, as the lower courts and the Treasury have interpreted it, *Crane* established that the same results generally obtain even if the debt is nonrecourse in nature so that the property owner has no obligation to satisfy the debt other than out of the property. In such a case, the borrowed funds are includable both in the borrower's cost basis and in the amount realized upon disposition.

3. As we have shown, the inclusion of borrowed funds in basis—where the receipt of such borrowing was not taxable—requires the *quid pro quo* of including the full amount of the unpaid debt in amount realized to insure that all potential for income is ultimately accounted for upon the sale or disposition of the property. If such were not the case, the taxpayer would have the best of both worlds—basis inflated by nonrecourse indebtedness, on the assumption that the debt will be paid by him, and the exclusion of the amount of the unpaid debt upon disposition, even though we then know with certainty that the taxpayer will not pay the debt because it has been transferred with the property. A rational tax system cannot simultaneously comprehend the adoption of such contradictory assumptions. Logic, and the statute's directive to tax all income "from whatever source derived," demand that if nonrecourse borrowed funds received tax free can purchase basis and the resultant tax deductions, then the unrepaid amount of such indebtedness must be included in amount realized upon the disposition of the property subject to the mortgage.

The correctness of this submission can be shown by returning once again to our example. Suppose the property that A purchased is a machine that can be fully depreciated in five years. At the end of the five-year term, A sells the machine subject to the unamortized

$75,000 nonrecourse mortgage for $5,000. At this point in time, the machine is presumably worth $80,000 since the purchaser is willing to pay $5,000 and take the machine subject to the $75,000 mortgage. A's basis in the machine (assuming no salvage value) is zero. Plainly, however, A's gain is not limited to the $5,000 in cash. Since A did not include the $75,000 nonrecourse loan in income at the outset on the assumption that he would pay off the loan, the termination of A's obligation to pay the loan requires the inclusion of the unamortized loan as part of the "amount realized" upon the sale of the machine. Indeed, this Court so held in *Crane.*

The assumption in the foregoing example that the machine was worth $80,000 at the time of sale makes it easier to appreciate the fact that A sold it for $80,000, and not for $5,000. In an arm's length exchange, one generally obtains property equal in value to what one gives up. See *United States* v. *Davis*, 370 U.S. 65, 72 (1962). Suppose, however, that at the end of the five-year term the machine is worth $40,000 and A finds a purchaser willing to take it subject to the unamortized mortgage of $75,000 (because of the loan terms or perhaps on the speculation that it will increase in value). Once again, A's basis is zero, since the machine is fully depreciated. But what is his amount realized on such a sale? If, as we submit, the termination of A's responsibility to repay the $75,000 loan should be the critical factor requiring an offsetting inclusion in income, the proper answer is $75,000, so that A has gain of $75,000 ($75,000 less his zero basis).

Despite the fact that the termination of A's $75,000 liability is a taxable event to him, the decision below required that the amount realized by A be limited to the fair market value of the machine, or $40,000. One might fairly ask what possible relevance the $40,000 value of the machine is to A? The only loss A has incurred is the loss of his original $25,000 cash investment. But A has garnered the benefit of $100,000 in tax deductions over the term of his ownership. Surely, A has not suffered any economic loss as a result of the decline in value of the machine. To the contrary, the decline in value of the machine is only of interest to the lender, who has advanced $75,000 on a nonrecourse basis. Indeed, if the lender is forced to foreclose on the property, he will suffer a $35,000 loss ($75,000 less $40,000), but that fact has no bearing upon A's economic or tax status. Hence, the decline in value of the machine should not alter the fact that A must account for $75,000 of gain once it becomes clear that he has terminated his obligation to repay the $75,000 loan.

C. The Termination of Respondents' Mortgage Liability Upon the Sale of Their Partnership Interests Requires the Inclusion of the Partnership's Mortgage Debt in the Amount Realized

1. The present case is simply a variation of the foregoing example. Here, respondents' partnership invested approximately $44,000 in cash in the apartment complex and financed the remainder of the project with a $1.85 million nonrecourse loan. During the partnership's ownership, respondents claimed approximately $440,000 in tax deductions with respect to the complex, which served to reduce their original partnership bases of $1,895,000. Thus, at the time of sale when the value of the property had declined to $1.4 million, respondents had an adjusted basis of approximately $1.45 million. To permit respondents to include only the $1.4 million fair market value (instead of $1.85 million) as the amount realized effectively sanctions deductions well in excess of any monetary outlay or other actual economic loss. What is more, it violates the assumptions under which the borrowed funds were initially excluded from respondents' income and included in their basis in their partnership.

Respondents' ability to claim depreciation and other deductions on a basis inflated by nonrecourse indebtedness and to escape taxation on the termination of that indebtedness graphically underscores the abuse countenanced by the decision below. It is, moreover, as we shall show, contrary to the "functional relation" in the Code between amount realized and basis, which is an essential part of the teaching of this Court's decision in *Crane* (331 U.S. at 12). As the Court there reasoned, as long as a nonrecourse indebtedness was includable in basis upon acquisition, it should also be included in amount realized upon disposition. If A need not exclude the $75,000 nonrecourse debt from his basis upon which depreciation and other deductions are computed, then he cannot be permitted to exclude that debt from the amount realized. Any other conclusion would permit the taxpayer to "enjoy a double deduction * * * on the same loss of assets" (*id.* at 16).

But quite apart from the "functional relation" between basis and amount realized that is most easily illustrated in the case of depreciable property, the fundamental error of the decision below does not turn on the fact that respondents (through their partnership) claimed depreciation and other deductions on their investment in the apartment complex. This becomes apparent if we consider an example involving nondepreciable property. Suppose that the $100,000 asset purchased by A in our previous example is not a depreciable machine but a parcel of undeveloped land, which is not a wasting asset eligible for depreciation. Again, A puts up $25,000 in cash and obtains a $75,000 nonrecourse mortgage loan to purchase the property. Suppose further that the value of the land declines to $70,000 and A disposes of it for no cash but subject to the mortgage. According to the court below, which ascribed significance to the value of the property as a limitation upon amount realized, A should have a loss of $30,000 ($70,000 less $100,000). But A's entire cash investment in the property was only $25,000. Surely A cannot claim a tax loss in excess of his actual economic loss. See *Freeland* v. *Commissioner*, 74 T.C. 970, 977-982 (1980).

Thus, the abuse permitted by the court of appeals in this case is not excessive depreciation deductions but the allowance of a tax loss far in excess of economic loss. It is therefore no overstatement to conclude that, under the ruling below, a person who borrows $1 million on a nonrecourse basis to purchase property for $1 million can claim a $900,000 tax loss on the subsequent sale of the property subject to the unamortized debt, if the value of the property declines to $100,000 during the period of his ownership, and before he has repaid any of the principal of the loan. This result, which permits a person to take a tax loss in excess of his actual economic loss, bears no relationship to economic reality.[18] The taxpayer has not disbursed a single dollar, and is not in any sense poorer than he was before the transaction. Indeed, it is the lender, not the taxpayer, who may bear the economic and tax loss attributable to the decline in value of the property in these circumstances.[19] But under the court of appeals' decision, respondents are permitted to claim a tax loss equal to the lender's potential economic loss.

2. Both the Commissioner and the court of appeals rest their opposing conclusions in this case upon this Court's decision in *Crane*. While the court below acknowledged that relief from nonrecourse debt should generally be included in amount realized, it concluded that this principle was not applicable when the value of the property is less than the principal amount of the mortgage, citing the observation in footnote 37 of this Court's opinion in *Crane*.

In our view, *Crane* does not support the aberrational result reached by the court below, and footnote 37 of the Court's opinion should not be read as requiring that result. Indeed, properly analyzed, *Crane* refutes the proposition that a decline in the value of property burdened by nonrecourse indebtedness produces a tax loss to the owner even though the economic loss associated with the decline in value is borne by the lender. We therefore now turn to a detailed discussion of this Court's decision in *Crane* to demonstrate the correctness of our submission that mortgage debt—that represents funds received that are not includable in income and are properly includable in the cost basis of property—is includable in amount realized upon disposition, regardless of the value of the property at the time of disposition.

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[18] See Drye, *The Income Tax Effect of Mortgages*, 17 Wash. & Lee L. Rev. 1, 4 (1960).

[19] Here, as we have noted (page 7, note 11, *supra*), HUD guaranteed the $1.85 million mortgage and was therefore the ultimate loser in the transaction. After foreclosure, HUD was able to sell the project for $1.5 million. Thus, the loss attributable to the project's decline in value was borne by the federal government, not by respondents.

D. This Court's Decision in *Crane* Requires Respondents to Include the Face Amount of Their $1.85 Million Mortgage in the Amount Realized Upon the Sale of Their Partnership

1. a. The starting point for any analysis of the tax consequences arising upon the sale of property subject to a nonrecourse mortgage is this Court's decision in *Crane* v. *Commissioner*, *supra*. In that case, the taxpayer's husband left her an apartment building that was subject to a mortgage securing a principal debt of $255,000 and interest in default of approximately $7,000. For almost seven years thereafter, the taxpayer operated the building and remitted the net rents to the mortgagee. During this period, she claimed (or would have been allowed) depreciation deductions of approximately $28,000, charged against a basis of $262,000, which was equal to the value of the property as of her husband's death (see 26 U.S.C. 1014). During the period of her ownership, the taxpayer made no principal payments on the mortgage. As a result, she reduced her tax basis in the property below the level of the outstanding mortgage debt. Almost seven years after her husband's death, with the mortgagee threatening foreclosure, the taxpayer sold the property to a third party subject to the mortgage for $2,500 in cash.

The question before the Court was "how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain" (331 U.S. at 2). To answer this question, the Court had to make two determinations—her basis in the property and the amount realized upon the sale. Disavowing the position she had taken during the years of her ownership that her initial basis in the property—the basis upon which she had claimed depreciation deductions—was $262,000, the taxpayer argued that the "property" that she had inherited was only her equity in the realty so that her basis was limited to her equity, or the excess in the value of the building over the amount of the mortgage, *i.e.*, zero. She further urged that because neither she nor her vendee ever became personally liable on the mortgage note, she only sold the equity, so that the amount she realized on the sale was the $2,500 net cash received. Since she claimed to have a zero basis, the taxpayer computed her gain at $2,500.

The Commissioner took issue with the taxpayer's positions both as to basis and amount realized. In the Commissioner's view, the taxpayer's original basis in the building was the date-of-death value of $262,000. Because she claimed (or would have been allowed) depreciation deductions of $28,000 during the period of her ownership, her basis was thereby reduced to $234,000. According to the Commissioner, the amount realized was the sum of the mortgage subject to which the property was sold ($255,000) and the net cash received ($2,500), or $257,500. Hence, the Commissioner charged the taxpayer with approximately $23,500 of gain: the $255,000 mortgage balance plus the $2,500 cash payment (amount realized), less her adjusted basis of $234,000.

The Court upheld the Commissioner's method of computation. It first concluded that "the proper basis under [the statute] is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,[000]" (331 U.S. at 11). As the Court noted, if a taxpayer's basis were limited to the equity in property, each payment on the mortgage would require recomputation of basis. Since the Treasury consistently had permitted depreciation to be computed on the full value of the property, the Court concluded that "Congress' long-continued acceptance of this situation gives it full legislative endorsement" (*id.* at 11; footnote omitted).

Turning to "amount realized," the Court held that the amount realized by the taxpayer upon her subsequent sale of the property included not only the $2,500 in cash but also the face amount of the nonrecourse mortgage to which the transferred property was subject. In so holding, the Court observed that the word "property" in the statutory definition of amount realized must have "the same ordinary sense intended by the use of the word with reference to [basis], both for certain of the reasons stated heretofore in discussing its meaning in [the basis provision], and also because the functional relation of the two sections requires that the word mean the same in one section that it does in the other" (331 U.S. at 12).[20] The Court therefore concluded that "the amount

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[20] In discussing the "functional relation" in the Code between amount realized and basis, the Court reasoned that since, as in the case here, the nonrecourse indebtedness was not excluded from the taxpayer's basis upon acquisition, neither should it be excluded from the amount realized upon disposition subject to the debt. The Court further noted that the taxpayer was in no position to urge that the amount she had realized on the disposition of the apartment building was any less than $2,500 in cash received plus the amount of the mortgage burdening the property. Otherwise, a double deduction would be available for a single loss. As the Court observed (331 U.S. at 15-16; footnote omitted):

> [The taxpayer] was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the [Revenue] Act [of 1938] itself.

In effect, the taxpayer in *Crane* took deductions for the presumed physical deterioration of the building, but at the same time was not willing to reduce her cost basis in the building by a like of the mortgage is properly included in the 'amount realized' on the sale" (331 U.S. at 13).[21]

b. In construing the statutory term "amount realized" in *Crane*, the Court noted the taxpayer's concession that the mortgage would have been includable in the "amount realized" if she had been personally liable on the note and the purchaser either had paid it or assumed it. In such a case, the purchaser's payment would have relieved the taxpayer of an indebtedness and constituted income, just as if the amount were paid directly to the taxpayer and then paid over by her to her creditors. The taxpayer argued, however, that the nonrecourse nature of her mortgage required a different result. Because she was not personally liable on the note, she urged that there was no cancellation of indebtedness that would be includable in amount realized.

But the Court rejected the taxpayer's reliance on the nonrecourse character of her mortgage, and in fact used her concession as support for its ultimate holding. In reasoning that the circumstances of *Crane* justified treat-

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amount. If the building had then declined in value as a result of that deterioration, the taxpayer in that circumstance, not having reduced her basis by the measure of prior depreciation deductions, would have been entitled to a second (and unwarranted) deduction for the same loss of assets. See *United States* v. *Ludey*, 274 U.S. 295, 301 (1927).

The "double deduction" analysis employed in *Crane* and followed by several of the lower courts may be viewed, in the broad sense, as a corollary to the functional relationship between basis and amount realized. Both analyses illustrate the impropriety of permitting a tax loss in the absence of an economic loss. See Note, *Millar: Requiem for Crane's Footnote 37?*, 41 U. Pitt. L. Rev. 343, 347 (1980).

[21] Although the Tax Court in *Crane* held that the amount realized by the taxpayer did not include the nonrecourse mortgage (*Crane* v. *Commissioner*, 3 T.C. 585 (1944)), it also excluded the mortgage from the taxpayer's basis in the property (*id.* at 591). Hence, the Tax Court likewise recognized the "functional relation" of the two sections. Indeed, at no time did the taxpayer in *Crane* argue, as do respondents here, that the mortgage was includable in basis but not in amount realized.

ing the nonrecourse mortgage just as if it were an obligation upon which she was personally liable, the Court stated (331 U.S. at 14; footnote omitted):

> [W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.[37] If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.
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> [37] Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

2. On the particular facts of *Crane*, the Court properly considered the nonrecourse mortgage to be economically equivalent to a personal obligation. If a person owns property worth $1,000, subject to a nonrecourse mortgage of $500, he will treat the mortgage the same as he would a personal obligation in order to protect his equity interest. Accordingly, the benefit derived upon

the transfer of the property subject to the mortgage can properly be analogized to the assumption of a personal debt.

These considerations, however, are not applicable to the case where, as here, the value of the property is less than the amount of the nonrecourse mortgage. In that situation, the owner will presumably not treat the mortgage as economically equivalent to a personal obligation because he has no equity interest to protect. Hence, if the debtor disposes of the property subject to the mortgage, he may not at that point in time have realized an economic benefit equal to the amount of the unpaid mortgage removed from his balance sheet. This is so because the value of the only property securing the debt is then less than the amount of the remaining liability. The Court in *Crane* therefore correctly suggested that its economic benefit analysis might not apply to the case where the value of the property is less than the amount of the mortgage. Accordingly, the Court stated (331 U.S. at 14 n.37):

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

But the reservation expressed by the Court in footnote 37 of its opinion in *Crane*, upon which the court of appeals seized, does not constitute authority for the ruling below that, when the value of the property is less than the amount of the mortgage, the amount realized upon sale for tax purposes must be limited to the value of the property. Properly read, the statement in footnote 37 simply reflects the Court's view that its economic benefit analysis, equating a nonrecourse mortgage with a personal obligation, does not necessarily apply where the value of the property is less than the nonrecourse mortgage.[22] As Professor Bittker has observed (Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277, 284 (1978)):

> These indefensible tax results arise only because footnote 37 of *Crane* attaches weight to something that cannot possibly affect the taxpayer once he disposes of the property, that is, its value. Whether the value of the property at that time is just barely sufficient to pay off the debt, or falls short of that amount, and what happens to its value thereafter, are matters of concern to the mortgagee and the new owner; but the old owner has no reason to worry about these matters. It has been argued above that the result in *Crane* can be justified only if the amount realized by a taxpayer who disposes of property encumbered by nonrecourse debt in excess of its basis is viewed as a balancing entry, which brings the tax results into conformity with economic reality. If this is its function, the amount realized should be computed by reference to the taxpayer's adjusted basis, the amount of the nonrecourse debt, and the cash or other property (if any) received by him. If it falls out that the property is worth less than the debt, that is the lender's misfortune; but this should no more affect the taxpayer's tax returns than it affects his economic position.

The present case is a perfect illustration of Professor Bittker's point. Respondents put up $44,000 in cash in their partnership and obtained a $1.85 million nonrecourse loan. At the time of their sale of their partnership interests subject to the mortgage, the value of the partnership's property had declined to $1.4 million. But the $400,000 decline in the value of the partnership's property has no bearing upon respondents' economic condition. That decline in value is the lender's potential loss insofar as it had advanced $1.8 million secured only by an asset worth $1.4 million.[23] The tax deductions permitted on the nonrecourse debt were premised upon the assumption that the debt eventually would be repaid by respondents and that they would in fact incur those costs.[24] When it turned out that respondents would not incur those costs but were able to satisfy the $1.8 million debt by transferring property worth $1.4 million, a reconciliation must occur. Hence, in order to put the accounts right, respondents' transfer of property subject to the $1.8 million mortgage requires a balancing entry of $400,000 in the amount realized.[25]

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[22] "Footnote 37 presents no problem if it is viewed only as a warning that the theory of the case then before the Court, although adequate to deal with the facts of that case, might not be adequate to deal with the facts of a harder one." Halpern, *Footnote 37 and the Crane Case: The Problem That Never Really Was*, 6 J. Real Est. Tax. 197, 224 (1979).

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[23] Here, the loss was actually sustained by the loan guarantor. As we have noted (page 7, note 11, *supra*), HUD guaranteed the $1.85 million mortgage. After foreclosure, HUD was able to sell the project for $1.5 million. Thus, the loss attributable to the project's decline in value was borne by the federal government and not by respondents.

[24] Here, the parties stipulated (J.A. 14) that the full face amount of the nonrecourse debt was properly includable in respondents' initial basis in their partnership.

[25] Contrary to the court of appeals' apprehension, a decision for the government in this case would not result in "taxing the taxpayer twice on the same component of gain" (Pet. App. 28a). As we have explained (page 17, *supra*), a taxpayer's basis in property must be adjusted downward to reflect depreciation and other tax deductions taken with respect to the property. 26 U.S.C. 1016. See *Virginian Hotel Co.* v. *Helvering*, 319 U.S. 523 (1943); *United States* v. *Ludey*, 274 U.S. 295 (1927). But those deductions are not subsequently added back to the gain equation for purposes of computing the amount realized on the sale of the property, as the court of appeals seemed to imply. Rather, the "amount realized" in these circumstances is dependent solely upon the indebtedness discharged as a result of the sale, not upon the prior deductions taken with respect to the property. The prior deductions are significant only because they show that the indebtedness was included in the taxpayer's basis for the property. It is the "functional relation" of basis to amount realized set forth in the Code and confirmed by *Crane* which requires the inclusion of the indebtedness in the amount realized when the property is sold—not the fact that deductions had been permitted with respect to the property. Indeed, as we have pointed out (see page 23, *supra*), the court of appeals'

Thus, viewed as a whole, the economic benefit of the transaction to respondents is plain. They received cash of $1.85 million when they received the nonrecourse loan. Since it was a loan, respondents did not take it into income. But that loan created basis in the partnership permitting respondents to claim approximately $400,000 ($440,000 in deductions less their cash investment of $40,000) in tax deductions associated with their partnership activities. In essence, respondents withdrew $440,000 in capital from their partnership in which they had invested only $40,000 of their own money. If only $1.4 million of the nonrecourse mortgage is included in the amount realized on the sale of the property, respondents will never have to account for the $400,000 in tax-free income realized from their investment. Although the sale of the partnership interests worth $1.4 million did not result in an economic benefit to respondents at the time of sale, because they were not personally obligated on the mortgage, it did fix the point at which it became clear that they will never pay back the full amount of the loan and never make the investment upon which the basis-reducing deductions they have been entitled to claim were grounded.[26]

Any other conclusion would be at odds with the Court's statutory analysis in *Crane*, which is fully applicable to

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decision in this case permits an unjustified tax loss whether or not prior depreciation deductions have been taken with respect to the property. While the availability of such deductions serves to reduce taxpayer's adjusted basis in the property, the deductions have no bearing on the measure of the amount realized when the property is ultimately sold subject to the unpaid debt.

[26] Indeed, since the taxpayer in *Crane* had never made any principal payments on the nonrecourse mortgage, the taxable gain determined by this Court in *Crane* in large measure reflected the tax deductions the taxpayer there had enjoyed solely by virtue of the nonrecourse mortgage. See *Diedrich* v. *Commissioner*, No. 80-2204 (June 15, 1982), slip op. 5 n.4: "In *Crane* the taxpayer received favorable tax treatment for the loan and was allowed depreciation on the property. The Court concluded that the taxpayer could not then later escape taxation after having received these benefits when the loan obligation was assumed by another."

the case where the value of the property is less than the mortgage. That analysis relied on the use of the common term "property" in the statutory definitions of "basis" and "amount realized," and concluded that "the functional relation of the two sections requires that the word mean the same in one section that it does in the other" (331 U.S. at 12; footnote omitted). The Court therefore cited with approval the lower court decisions in which "It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole" (*id.* at 13).

Accordingly, because of the "functional relation" between basis and amount realized, the inclusion of funds borrowed on secured nonrecourse terms in basis requires inclusion of the relief from such liability in amount realized when the property is disposed of subject to the mortgage, whatever the fair market value of the property at the time of disposition. The court of appeals' contrary declaration that "[t]here is simply no relationship between basis, adjustments to basis, and amount realized" (Pet. App. 35a n.9) cannot be squared with *Crane*.[27]

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[27] The concurring opinion of Judge Williams (Pet. App. 35a-40a) can no more be reconciled with *Crane* than the majority opinion. Although he recognized the "grave consequences" produced by the decision below (Pet. App. 40a), Judge Williams argued that the release of the nonrecourse debt should be treated as property other than money (see 26 U.S.C. 1001(b)), the value of which should be determined by the fair market value of the property burdened by the debt. That analysis, however, does not withstand scrutiny. There is no rule of law that would fix the value of the release of nonrecourse debt to be equal to the value of the property it secures. The value of the release of a debt is necessarily equal to the amount of the debt, *i.e.*, $1.85 million, the amount originally borrowed by respondents and included in their bases on the assumption that they would pay it back. Thus, the flaw in Judge Williams' analysis is the same as the error in the majority opinion—its allowance of a loss far exceeding respondents' ~~enormous~~ ECONOM loss and its disregard of the functional relation between basis and amount realized established in the Code and confirmed by *Crane*.

3. Finally, the statutory language of Section 1001(b), which defines "amount realized" in terms of money and property received, supports the inclusion of the relief from nonrecourse debt in amount realized, without regard to the value of the property at the time of sale. Where property is subject to a liability that exceeds the value of the property at the time of transfer, the transferor can be viewed as having received the excess consideration from the lender (not from the transferee). Since the statute speaks of "any" money, the amount realized need not be confined to money paid by the transferee at the time of sale. Rather, Section 1001(b) is properly read to require that all consideration, whenever and from whomever received, be taken into account at the time of sale or disposition. The statutory term "amount realized" can be read to encompass a discharge from the obligation to repay money previously borrowed.

E. Until the Decision Below, the Lower Courts Consistently Interpreted *Crane* to Require the Inclusion of the Full Amount of the Nonrecourse Debt in Amount Realized Regardless of the Value of the Property Upon Disposition

Until the decision below, an unbroken line of authority has required the inclusion in amount realized of the full amount of the indebtedness transferred with the property, regardless of the value of the property upon disposition.

1. The decisions of the Tax Court, for example, have consistently held, for almost 40 years, that the fair market value of property burdened by nonrecourse debt does not mark the upper limit of the amount realized on a sale of property subject to that debt. In *Lutz & Schramm Co.* v. *Commissioner*, 1 T.C. 682 (1943), a pre-*Crane* case, the taxpayer acquired a piece of property in 1924 and the next year borrowed $361,000 from E.R. Crawford on a recourse basis and secured by the property. In 1934, Crawford agreed to reduce the debt to $300,000 and, in addition, released the taxpayer from personal lia-

bility on the loan. In 1937, when the fair market value of the property had fallen to $97,000 and its adjusted basis in the taxpayer's hands was approximately $257,000, the taxpayer transferred the property to Crawford's representatives in satisfaction of the unamortized debt of $300,000. On these facts, the Tax Court held, without dissent in this regard, that the taxpayer realized a gain of $43,000 on the transfer, the difference between the face amount of the debt and his adjusted basis in the property.[28] Since the taxpayer there had realized the "full benefit" of the loan when it was received, the loan had to be included in the amount realized when it was subsequently discharged. As the court here stated, in terms that likewise refute respondents' claim in this case (1 T.C. at 689; emphasis supplied):

> The petitioner argues against this result by calling attention to the fact that the fair market value of the property was only $97,000 at the time of the transfer in 1937, and to the fact that in 1934 the creditor had agreed to look only to the property covered by the mortgage in enforcing his rights for repayment of the debt. *The fair market value of the property transferred is immaterial under the provisions of the revenue act in the computation of gain or loss from the disposition of the property.* Likewise, it is immaterial that the petitioner was released from personal liability for the repayment of this debt in 1934. This petitioner was not insolvent and the question is not whether it realized income from the discharge or forgiveness of indebtedness, * * * but is rather whether it realized gain from the disposition of a piece of real property. There is no question of the fact that the petitioner had received and used for its own benefit the $300,000 and the only repayment it made on this part of the debt was the transfer of the property. The debt was finally

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[28] The taxpayer in *Lutz & Schramm Co.* had initially reported this amount as gain on its income tax returns, but subsequently sought a refund on the ground that the gain on the property transferred was erroneously reported (see 1 T.C. at 685).

> satisfied by that transfer * * * and the net result of it was that the petitioner, over a period of years, had enjoyed the full benefit from the receipt of $300,000 by transferring a property which had a basis in its hands for gain or loss of only $257,435.42. The petitioner has failed to demonstrate that it did not realize the gain which it reported.

Mendham Corp. v. *Commissioner*, 9 T.C. 320 (1947), is to the same effect. There, the taxpayer corporation mortgaged property for $325,000 on a nonrecourse basis in 1928. Eleven years later, when the principal amount of the debt outstanding remained at $325,000, the property securing that debt was sold pursuant to a foreclosure proceeding. At the time of sale, the property was worth only $165,000. Following *Lutz & Schramm Co., supra*, and *R. O'Dell & Sons Co.* v. *Commissioner*, 8 T.C. 1165 (1947), the Tax Court held that the taxpayer realized gain on the transaction to the extent the face amount of the mortgage discharged in foreclosure exceeded the taxpayer's adjusted basis in the property. Otherwise, the court reasoned, the taxpayer would never have to account for the economic benefit received from the initial nonrecourse borrowing (9 T.C. at 323-324):

> The resulting indebtedness prevented the original borrowing from creating gain, but the transaction was completed when the mortgage was discharged in exchange for a conveyance of the property, the final disposition of which thus established as taxable income the difference between the basis for the property and the amount acquired from the earlier borrowing.
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> * * * * *
>
> It is only the reduction of basis for depreciation deductions previously allowed which leads to the attribution to petitioner of any profit on the sale. This * * * is necessary to a proper consideration of the gain in such a case as this, under the principle of *Crane* v. *Commissioner*, 331 U.S. 1.

Similarly, in *Woodsam Associates, Inc.* v. *Commissioner*, 16 T.C. 649 (1951), aff'd, 198 F.2d 357 (2d Cir. 1952), the Tax Court held, in a reviewed decision again without dissent, that the face amount of nonrecourse debt discharged by a sale of property securing the debt constituted an amount realized on the sale. In that case, the taxpayer's nonrecourse mortgage of $381,000 was extinguished by virtue of a foreclosure sale of the property burdened by the debt. At the time of foreclosure, the taxpayer's adjusted basis in the property was approximately $235,000. Claiming that the property's fair market value at the time of foreclosure did not exceed $320,000, the taxpayer, citing footnote 37 of this Court's opinion in *Crane*, argued that the amount "realized" as a result of the foreclosure sale was limited to $320,000 (16 T.C. at 654-655). The Tax Court rejected that contention as "untenable," stating (*id.* at 655):

> If the footnote from the *Crane* case rises above the status of dictum, we are unable to conclude that it is of any application, at least in circumstances such as those here presented where the entire rationale must be dependent upon the concept of basis and "realized" gain on foreclosure. Petitioner cannot elude the impact of the fact that it realized an economic gain of $146,058.10 [$381,000 mortgage less adjusted basis of $234,941.90] when the mortgage was foreclosed.

Finally, in *Millar* v. *Commissioner*, 67 T.C. 656 (1977), aff'd on this issue, 577 F.2d 212 (3d Cir.), cert. denied, 439 U.S. 1046 (1978), the taxpayers had borrowed funds under nonrecourse terms and contributed those funds to their Subchapter S corporation. Under Subchapter S of the Code (26 U.S.C. 1371-1379), the expenses and losses incurred by their corporation were passed through to them and served to reduce their tax bases. As a result, the taxpayers in *Millar* had virtually exhausted their tax bases when their corporation eventually failed. At that time, the lender foreclosed upon the shares of stock in the taxpayers' Subchapter S corporation in full satisfaction of the outstanding nonrecourse debts. On those facts, the Tax Court unanimously held that the taxpayers realized the full amount of the outstanding nonrecourse debt when they conveyed their shares in satisfaction of that debt, even though the shares were then worthless. In the Tax Court's view, the value of the property subject to the encumbrance was "immaterial" (67 T.C. at 660).[29] Since the taxpayers "had received a cash equivalent in the amount of the notes, whether they were personally liable on such notes or not" (*id.* at 660-661), the court in *Millar* ruled that the full amount of the notes had to be taken into consideration when the taxpayers were relieved of the liability on the notes. As the concurring opinion noted (*id.* at 662):

> The crux of *Crane* v. *Commissioner*, 331 U.S. 1 (1947), is that the taxpayer received a benefit at least equal to the nonrecourse debt. * * * The tax law must not be construed in a vacuum. Petitioners have received a tax benefit of economic substance attributable to the use of their *Crane* basis. When the property is disposed of, petitioners must account for these deductions.

The Third Circuit affirmed the Tax Court in *Millar*. In holding that the full amount of the mortgage had to be included in the amount realized on the foreclosure despite the fact that the stock was worthless at the time of foreclosure, the court reasoned (577 F.2d at 215):

> While not personally liable upon the loan from Jamison, the taxpayers utilized those funds to increase the basis of their stock, which then permitted them to claim sizable deductions calculated against that basis. See 26 U.S.C. §§ 163, 1374(a), (b). Having substantially reduced the adjusted basis of their stock in this manner and thereafter surrendering their devalued stock in exchange for the cancellation of their indebtedness, the taxpayers clearly realized

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[29] Accord, *Estate of Delman* v. *Commissioner*, 73 T.C. 15 (1979). There, the Tax Court followed its decision in the instant case and held that the "amount realized upon the disposition of property includes the balance due on the nonrecourse liability even if it exceeds the fair market value of the property" (*id.* at 28).

> taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock. A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane.*

Nor did the court of appeals in *Millar* believe that footnote 37 in *Crane* required the opposite result. Rather, it concluded that the footnote "should be evaluated in the proper context" (557 F.2d at 215). As the court stated (*id.* at 215-216):

> First, it must be remembered that the footnote in *Crane* was *dictum.* Furthermore, the footnote was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances. Viewed in that perspective, we believe that the rationale of the Supreme Court's principal reasoning, analysis and holding in *Crane* is more clearly the measure by which the transaction *sub judice* should be decided. Thus, applying *Crane* to the facts of the case before us, it is clear that the transaction resulted in taxable gain to the taxpayers by reason of the inclusion of the nonrecourse obligation in the calculation of basis as well as the amount realized when computing the presence or absence of gain resulting to the taxpayers from the foreclosure of the notes and surrender of the stock.

2. Apart from the court below, the other courts of appeals have similarly read *Crane* in accordance with our submission. In *Estate of Levine* v. *Commissioner,* 634 F.2d 12 (1980), the Second Circuit concluded that the functional relationship between borrowed funds being included in basis and amount realized required inclusion of the nonrecourse debt in the amount realized on the sale of the property subject to that debt. "Any other

course," as Judge Friendly noted (*id.* at 15), "would render the concept of basis nonsensical by permitting sellers of mortgaged property to register large tax losses stemming from an inflated basis and a diminished realization of gain. It would also permit depreciation deductions in excess of a property holder's real investment which could never subsequently be recaptured." Although footnote 37 of *Crane* was not directly implicated in *Estate of Levine* (634 F.2d at 16 n.9), the decision in that case, by focusing on the tax-free economic benefit of the initial nonrecourse borrowing, makes it clear that the amount realized on the disposition of property subject to nonrecourse debt must be the full measure of the unrepaid debt. Indeed, *Estate of Levine* reaffirmed the rationale that the Second Circuit had applied 30 years earlier in *Woodsam Associates, Inc.* v. *Commissioner*, *supra*, 198 F.2d at 357, where the court, in commenting upon the taxpayer's decision not to rely on footnote 37 of *Crane*, stated (198 F.2d at 358 n.1): "[T]he petitioner has disclaimed reliance upon that [footnote 37 of *Crane*] and, we think, advisedly so. Cf. *Parker* v. *Delaney*, 1 Cir., 186 F.2d 455."[30]

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[30] The court's citation of *Parker* v. *Delaney*, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951), in *Woodsam Associates*, lends further support to our position here. In *Parker*, a taxpayer acquired certain apartment buildings subject to a nonrecourse mortgage, without investing any of his own resources. During the period he held the buildings, he claimed depreciation deductions and reduced his basis in the properties accordingly. After the taxpayer had claimed deductions that reduced his tax basis below the outstanding mortgage amount, the lender foreclosed upon the properties. On these facts, the court held that the taxpayer realized a gain upon the foreclosure measured by the difference between his basis and the amount of the outstanding loan. Inasmuch as the taxpayer in *Parker* had failed to show that the apartments were worth less on the date of foreclosure than the principal amount owing on the nonrecourse loans, the court did not have to decide the precise question involved here, *i.e.*, whether the full amount of the indebtedness should be included in the amount realized where the value of the

Finally, in accord with the Tax Court and the First, Second and Third Circuits, the Seventh Circuit has recently concluded that footnote 37 of *Crane* does not establish an exception to the principal holding of that case. In *Laport* v. *Commissioner*, 671 F.2d 1028 (1982), the court held that the taxpayer's surrender of property burdened by nonrecourse debt constituted a sale or exchange and not an abandonment, so that the ensuing loss was capital in nature. In reaching that conclusion, the court rejected the taxpayer's claim—based on footnote 37 of *Crane*—that he did not "benefit" from the resulting discharge of the nonrecourse indebtedness. As the court observed (671 F.2d at 1034; footnote omitted), acceptance of the taxpayer's theory "upsets the symmetry that the *Crane* case as a whole had established. For under *Crane* a taxpayer could acquire a basis in an asset with borrowed funds, whether the borrowing was recourse or nonrecourse. And under *Crane* a taxpayer had to account for the borrowed funds when he sold the asset, whether the borrowing was recourse or nonrecourse."

Thus, the court below stands alone in its interpretation of footnote 37 of the *Crane* opinion. As we have demonstrated, every other court that has addressed the issue presented in this case has held that there is no fair market value "cap" upon the amount realized by the taxpayer when he disposes of property subject to nonrecourse indebtedness. Nor have any of the commentators who have expressed an opinion on this issue advocated the

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property is less than the debt (*id.* at 458). But the rationale of its decision leaves little room to doubt how it would have decided it. By noting that the gain taxed to the taxpayer there reflected the prior tax deductions enjoyed by virtue of the inclusion of the nonrecourse debt in the taxpayer's basis for the property (*id.* at 457-458), the court indicated that a proper accounting for those benefits —rather than the value of the property on the date of foreclosure— was the factor critical to its decision.

position adopted by the court of appeals in this case.[31] And given the aberrational results produced by the court below, the virtual unanimity of judicial and professional opinions is hardly surprising. Accordingly, the fair market value of property burdened by nonrecourse indebtedness has no relevance to the tax consequences of the property's disposition.

3. The pertinent Treasury Regulations are in accord with the body of decisional law we have described. Section 1.1001-2 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), promulgated on December 12,

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[31] The commentators are unanimous in the view that taxable gain results from the discharge of nonrecourse indebtedness in excess of basis, regardless of the property's fair market value at the time of disposition.

See, *e.g.*, Adams, *Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 Tax L. Rev. 159 (1966); Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277 (1978); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. Pa. L. Rev. 69 (1969); Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis*, 26 Buffalo L. Rev. 219 (1977); Drye, *The Income Tax Effect of Mortgages*, 17 Wash. & Lee L. Rev. 1 (1960); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225 (1959); Ginsburg, *The Leaky Tax Shelter*, 53 Taxes 719 (1975); Halpern, *Footnote 37 and the Crane case: The Problem That Never Really Was*, 6 J. Real Est. Tax. 197 (1979); Johnson, *Tax Models for Nonrecourse Employee Liability*, 32 Tax L. Rev. 359 (1977); Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 Tax L. Rev. 525 (1972); Rubin, *Tax Problems in Real Estate Mortgages Transactions*, 1960 Tul. Tax Inst. 524; Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?*, 53 S. Calif. L. Rev. 1 (1979); Simmons, *Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote 37*, 59 Or. L. Rev. 3 (1980); Simmons, *Tufts* v. *Commissioner: Amount Realized Limited to Fair Market Value*, 15 U. Calif. D. L. Rev. 577 (1982); Spears, *Mortgages in Excess of Basis*, 1959 S. Calif. Tax Inst. 883; Townsend, *Footnote 37 of Crane: What is the Nature of the Income*, 4 Rev. of Tax. of Individuals 128 (1980).

1980 (T.D. 7741, 1981-1 Cum. Bull. 430 (45 Fed. Reg. 81744 (1980))), explicitly provides that the fair market value of property transferred subject to nonrecourse indebtedness "is not relevant" in determining the amount realized on the transfer. It states (Pet. App. 46a):

> Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property.

Example (7) of that Regulation (26 C.F.R. 1.1001-2, at 685) is particularly relevant, for it describes a factual situation presenting the same issues as the case at bar:

> *Example (7).* In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 — $16,500).

Such Treasury Regulations, of course, are entitled to great deference. See *National Muffler Dealers Association* v. *United States*, 440 U.S. 472, 488 (1979); *Crane* v. *Commissioner*, *supra*, 331 U.S. at 7.

Although Section 1.1001-2 of the Treasury Regulations was promulgated while this case was pending in the court of appeals, that regulation did not announce a new policy with respect to the tax treatment of nonrecourse indebtedness. To the contrary, Treasury Regulations in force since 1926 have consistently taken the position that the amount realized on the sale of mortgaged property includes the amount of the mortgage, whether the debt is recourse or nonrecourse in nature.[32] Thus, Treas. Reg. 69, Art. 44 (1926 Revenue Act), dealing with installment sales, provided that "[i]n the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, * * * shall be included as part of the 'purchase price'." [33] Treas. Reg. 74, Art. 69 (1928 Revenue Act), prescribing taxable gain on the sale of capital assets by a corporation, is to the same effect. It likewise provided that "[i]f the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the selling price." [34]

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[32] In 1976, the Internal Revenue Service issued a revenue ruling determining that the amount realized on the sale of property subject to nonrecourse indebtedness included the full amount of the debt, despite the fact that the fair market value of the property sold was less than the debt. Rev. Rul. 76-111, 1976-1 Cum. Bull. 214.

[33] Accord, Treas. Reg. 74, Art. 352 (1928 Revenue Act); Treas. Reg. 77, Art. 352 (1932 Revenue Act); Treas. Reg. 86, Art. 44-2 (1934 Revenue Act); Treas. Reg. 94, Art. 44-2 (1936 Revenue Act); Treas. Reg. 101, Art. 44-2 (1938 Revenue Act); Treas. Reg. 103, § 19.44-2 (1939 Code); Treas. Reg. 111, § 29.44-2 (1939 Code); Treasury Regulations on Income Tax (1954 Code), Section 1.453-4(c) (26 C.F.R.); Temporary Treasury Regulations on Income Tax (1954 Code), Section 15A.453-1(b)(2)(ii) (1981) (T.D. 7768, 1981-1 Cum. Bull. 296, as amended by T.D. 7788, 1981-44 Int. Rev. Bull. 15).

[34] Accord, Treas. Reg. 77, Art. 69 (1932 Revenue Act); Treas. Reg. 86, Art. 22(a)-19 (1934 Revenue Act); Treas. Reg. 94, Art. 22(a)-19 (1936 Revenue Act); Treas. Reg. 101, Art. 22(a)-19 (1938 Revenue Act); Treas. Reg. 103, § 19.22(a)-19 (1939 Code); Treas. Reg. 111, § 29.22(a)-18 (1939 Code). See *Brons Hotels, Inc. v. Commissioner*, 34 B.T.A. 376, 379 (1936).

F. The Partnership Provisions of the Internal Revenue Code Do Not Support the Decision Below

Section 752(c) of the Internal Revenue Code of 1954, upon which the court of appeals relied (Pet. App. 32a-33a n.8), does not support the decision below. That provision, which deals with the treatment of certain liabilities in the partnership context, states that "a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property" (*id.* at 43a). The courts below properly noted (*id.* at 15a-16a, 33a n.8) that Section 752 was intended to codify the rule of law established in *Crane.*

But as the Tax Court correctly pointed out (Pet. App. 16a-18a), the legislative history of Section 752(c) demonstrates that Congress intended that the fair market value limitation of that provision would apply only to actual or constructive contributions to, and distributions from, the partnership; it was not intended to affect outright sales of partnership interests, as in the present case. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A236, A237 (1954) (mentioning the fair market value limitation only in connection with contributions to and distributions from the partnership); S. Rep. No. 1622, 83d Cong., 2d Sess. 405 (1954) (same).[35] Accord, *Estate of*

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[35] The legislative history of Section 752(c) provides, in pertinent part, as follows (H.R. Rep. No. 1337, 83d Cong., 2d Sess. A236 (1954)):

> Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of encumbered property by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities. * * *
>
> The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.

[Footnote continued on page 47]

Delman v. *Commissioner*, *supra*, 73 T.C. at 15, 33-34. Moreover, the Tax Court further pointed out (*ibid.*) that this conclusion is reinforced by the pertinent Treasury Regulations (26 C.F.R. 1.752-1(c) and (d)), which similarly set forth the fair market value limitation only in connection with contributions to and distributions from the partnership. We therefore rely upon the Tax Court's construction of Section 752(c).

Indeed, the court of appeals' contrary analysis creates an unwarranted disparity between the treatment of nonrecourse indebtedness transferred in conjunction with a sale of a partnership interest and nonrecourse indebtedness transferred in conjunction with any other sale of property. Such a result would squarely conflict with Section 752(d) of the Code, which independently provides that in the case of a sale or exchange of a partnership interest, "liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships" (Pet. App. 43a). Given this independent congressional directive, there is no justification, in the absence of affirmative legislative history, for construing Section 752 (c) to require different tax results for taxpayers who are partners and those who invest as individuals. Consistent with the Tax Court's analysis in this respect, the leading authorities on partnership taxation have proposed that Section 752(c) be construed in accordance with our submission. See 1 W. McKee, W. Nelson, & R. Whitmore, *Federal Taxation of Partnerships and Partners* ¶ 7.-4, at 7-14 to 7-15 (1977). Section 752(c) accordingly does not support the decision below.[36]

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[35] [Continued]

Respondents therefore err in characterizing (Br. in Opp. 4 n.5) Section 752(c) as "imposing a 'fair market value' limitation in partnership situations involving contributions, distributions and *sales*" (emphasis supplied).

[36] As we noted in our brief in the court of appeals (at 42 n.22), it could be argued that Section 752(c) operates to require both the partnership and the partners to make adjustments to their tax bases when the partnership interests are sold, in order to reflect the difference between the mortgage amount and the mortgaged

G. Congress Has Recognized That Nonrecourse Mortgage Debt Must Be Included in Amount Realized Upon the Disposition of the Property

Finally, Congress has recognized that a transferor of property subject to nonrecourse debt should include the face amount of that debt in the amount realized upon sale.

As part of the Tax Reform Act of 1976, Congress added Section 465 to the Code of 1954 to deal with the abuses caused by limited partnership tax shelters that promised deductions inflated by nonrecourse liabilities. In reporting out the measure, the Senate Finance Committee pointed out (S. Rep. No. 94-938, 94th Cong., 2d Sess. 46 (1976)) that Section 1.752-1(e) (26 C.F.R.) of the Regulations, provides that where none of the partners has personal liability for a partnership obligation, all of the partners, including limited partners, share in the liability. Since a limited partner is deemed to have a share of such nonrecourse liabilities, the adjusted basis of the limited partner's interest in the partnership is correspondingly increased by his aliquot share of those liabilities.

The inclusion of such liabilities in basis, as the Senate Committee recognized (S. Rep. No. 94-938, *supra*, at 46), "arises from a judicially developed principle known as the *Crane* rule." The Committee Report continued—

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property's fair market value at the time of sale. According to this theory, the decline in the partnership's liability from $1,851,500 to $1,400,000 requires a reduction in the partners' respective shares of partnership liabilities, which, in turn, constitutes a constructive distribution of money to them. 26 U.S.C. 732(b). Under Section 733, that constructive distribution of $451,500 would lower the partners' aggregate basis in the partnership from $1,455,739 (see page 6, *supra*) to approximately $1,000,000. In that event, of course, the $400,000 spread between the partners' lowered basis and the fair market value of the property at the time of sale would be taxable to them as gain realized on the sale of their partnership interests. See Aronsohn, *The Financially Troubled Partnership*, 1976 N.Y.U. Tax Inst. 327, 350; Simmons, *Tufts* v. *Commissioner: Amount Realized Limited to Fair Market Value*, 15 U. Calif. D. L. Rev. 577, 614-615 (1982).

> The *Crane* rule is derived from the Supreme Court's reasoning in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), where it was held that an owner's adjusted basis in a parcel of real property included the amount of a nonrecourse mortgage on the property, under which the mortgagee-lender could seek a recovery of its loan only from the property. (It is because of the *Crane* rule that nonrecourse indebtedness is generally included in an investor's adjusted basis, as indicated above, in a business or productive property.)

Under the "at-risk" rules first enacted by Congress in 1976, a taxpayer's deductible loss in connection with certain prescribed activities[37] could not exceed the total amount of cash invested, the adjusted basis of other property contributed to the activity, amounts borrowed for use in the activity with respect to which the taxpayer was personally liable, plus nonrecourse liability secured by the taxpayer's personal assets, rather than the investment property. But in enacting these rules, Congress made it clear that it "only intended to limit the extent to which certain losses in connection with the covered activities may be deducted in the year claimed by the taxpayer" (S. Rep. No. 94-938, *supra*, at 48). As a result, the other rules prescribed by *Crane* with respect to basis and amount realized, for purposes of reporting gain or loss, remain undisturbed. In this respect, Congress left no doubt that nonrecourse debt was to be included in amount realized upon the sale of every type of property. Thus, the Joint Committee Explanation (Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess.,

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[37] The at-risk rules were first adopted with respect to: (1) farming (except farming operations involving trees other than fruit or nut trees); (2) exploring for, or exploiting, oil and gas resources; (3) holding, producing, or distributing motion picture films or video tapes; and (4) equipment leasing. The at-risk rules apply to all taxpayers (other than corporations which are not Subchapter C corporations). In 1978, Congress extended the "at-risk" rules "to all activities except real estate" (see Staff of the Joint Comm. on Taxation, 95th Cong., 2d Sess., *General Explanation of the Revenue Act of 1978*, at 131 (Jt. Comm. Print 1979)).

General Explanation of the Tax Reform Act of 1976, at 79 (1976), *reprinted in* 1976-3 Cum. Bull. 1, 91; emphasis supplied) stated:

> In the case of a partnership, the individual partners are generally allocated a share of the partnership's depreciation recapture in accordance with the provisions of the partnership agreement concerning the allocation of partnership gains. The recognition of depreciation recapture by a partner may be triggered directly by a sale of the partner's interest in the partnership itself. Also, if a lender forecloses on the debt used to finance the partnership's purchase of the equipment, this is treated as a disposition which will trigger recapture. *The amount "received" in a foreclosure will include the unpaid nonrecourse debt.*

The effect of the decision below, however, is to accord all investments financed with nonrecourse loans a tax preference upon sale or disposition that Congress believed to be unavailable to *any* type of investment, either before or after its enactment of the at-risk rules. Such an anomalous result, contrary to both *Crane* and Congress' understanding of the tax consequences of the sale of property subject to nonrecourse debt, should not be permitted to stand.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Treasury Regulations on Income Tax (1954 Code), Section 1.1001-2 (26 C.F.R.):

> Reg. § 1.1001-2 (T.D. 7741, filed 12-11-80.) Discharge of liabilities.
>
> (a) Inclusion in amount realized—(1) In general. Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.
>
> (2) Discharge of indebtedness. The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).
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> (3) Liability incurred on acquisition. In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.
>
> (4) Special rules. For purposes of this section—
>
> (i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;
>
> (ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);
>
> (iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) Effect of fair market value of security. The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtness.

(c) Examples. The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example (1). In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of $3,100. During the same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in the asset is $6,900 ($10,000 − $3,100) A realizes a gain of $2,300 ($9,200 − $6,900).

Example (2). Assume the same facts as in example (1) except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addiiton, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale.

Example (3). In 1975 L becomes a limited partner in partnership GL. L contributes $10,000 in cash to GL and L's distributive share of partnership income and loss is ten percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is $20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is $15,000. M pays $10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, $15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is $25,000 [$10,000 + $15,000]. L's gain realized on the sale is $5,000 [$25,000 − $20,000].

Example (4). In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 [$9,000 − $3,000].

Example (5). In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 − $1,200).

Example (6). In 1977 D purchases an asset for $7,500. D pays the seller $1,500 in cash and signs a note payable to the seller for $6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling $4,200 thereby reducing D's basis in the asset to $3,300 ($7,500 − $4,200). In 1979 D transfers the asset to a trust which is not a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D $750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to $4,700. D's amount realized on the transfer is $5,450 ($4,700 + $750). Since D's adjusted basis is $3,300, D's gain realized is $2,150 ($5,450 − $3,300).

Example (7). In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to be the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 − $16,500).

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposiiton of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

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Respondent’s Brief

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In The

Supreme Court of The United States

October Term, 1982

Commissioner of Internal Revenue,
Petitioner,

v.

John F. Tufts and Mary A. Tufts, et al.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

Whether the statutory definition of "amount realized" in Section 1001(b)* should be expanded by including a tax benefit concept and whether the statutory scope of Section 752(c) should be limited by ignoring its reference to all of Section 752.

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* References to "Section" and "Code" are to the Internal Revenue Code of 1954, as amended.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
JOHN F. TUFTS and MARY A. TUFTS, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENTS

I. STATEMENT ON THE FACTS OF THE CASE.

Petitioner's statement of "The Facts of This Case" (Pet. Br. 2-9) is essentially correct. Two points, however, should be clarified.

First, this case does not involve debt secured by property of equal or greater value at the time of disposition of the property. The value of Respondents' property, "Westwood Townhouses", had declined to a value of $1,400,000 at a time when the mortgage was $1,800,000. Petitioner's arguments must be read with that understanding. Second, Respondents have renounced any claim for the deduction of a loss on the sale of the partnership interests. Respondents did not claim a loss in their tax returns. Although the allowability of the loss was raised in their petition to the Tax Court, Respondents subsequently abandoned that claim and did not raise that issue in the Fifth Circuit Court of Appeals. Respondents acknowledge that the loss is not deductible since they did not recognize a true economic loss.

II. SUMMARY OF ARGUMENT.

A. The Issue Is Statutory Interpretation of "Amount Realized".

Section 1001(b) defines and limits the "amount realized" on a sale or disposition to "money received plus the fair market value of the property (other than money) received". Respondents contend that the statute refers to and includes only tangible and current considerations received. Measurable "economic benefit" is the proper justification for any expansion of the statute's scope. *Crane v. Commissioner,* 331 U.S. 1 (1947)[1], explicitly declined to expand "amount realized" beyond its own fact situation: fully secured debt. The definition of amount realized should not be further expanded to include "recapture" of earlier tax benefits.

B. Petitioner Seeks Expansion of "Amount Realized" To Include "Tax Benefits".

The law prior to 1976 allowed taxpayers to enjoy depreciation deductions based upon the inclusion of so-called "non-recourse debt" in a property's *cost basis.* Petitioner argues that it would be unfair to allow taxpayers to enjoy those tax benefits without subsequently disgorging them upon disposition of the property. This concept of "tax benefit" recapture has not been adopted by Congress, which has enacted a number of other recapture provisions (*e.g.*, Sections 111, 1245 or 1250). Petitioner asks this Court to act and expand the definition of "amount realized" to include non-recourse debt which created depreciable cost basis even though the debt exceeds its collateral so that no economic benefit occurred on sale or disposition.

---

[1] This Supreme Court decision shall sometimes be referred to as "*Crane*".

C. The "Loophole" is the Allowance of Deductions without True Economic Risk; Respondents Agree that Loophole Should Be Closed.

Crane held that non-recourse debt could create cost basis for depreciation deductions. Many tax oriented strategies have relied on that concept. In 1976, Congress started to close that loophole through the enactment of "at-risk" provisions (now, § 465), which cover all types of activities, but not real estate. Congress chose to deal with deductibility of loss, not the inclusion of tax benefits in "amount realized". The denial of the deduction at the outset is preferable to the distortion of amount realized in later years. Congress' response to these overstated deductions is the proper solution to this serious problem.

D. Taxable Income Should Be Limited to a Natural Concept of Realized Economic Benefit.

But for the earlier depreciation deductions, no one would assume that a profitless venture which consumed more capital than it produced should be taxed. Economic reality is the foundation of our taxing system. The administrative ease and perceived fairness of limiting income tax to demonstrable economic gain justifies a tax only on true economic benefits unless Congress legislates otherwise.

E. Congress and the Internal Revenue Service Have Generally Agreed that Economic Benefit, Fair Market Value, and Economic Substance Are the Linch-Pins in Our Taxing System.

Tax legislation consistently identifies fair market value as a genuine limitation on proper tax consequences. This Court and, usually, the Internal Revenue Service, have consistently maintained that taxation is a practical thing based upon economic reality and substance. The same principles, applied here, confirm that Respondents enjoyed no profit on the disposition of their partnership interests.

F. A "Tax Benefit" Concept of Amount Realized Would Result in an Unpredictable Rule which Would Require Subsequent Legislative Correction.

Many circumstances, which do not actually fit into Petitioner's "tax benefit" scenario, would nevertheless fall within the broad sweep of a judicially redefined "amount realized". That term applies to the disposition and sale of all kinds of properties. Petitioner's future interpretation of Section 1001(b) would apply any favorable ruling from this Court without limitation whenever a "tax benefit" concept of "amount realized" would enhance the Federal revenues. Congress should and will have to act if the disposition of properties not within the particular factual context of this case is to be affected.

G. Congress Has Not only Acted To Close the Non-Recourse Loophole with At-Risk Legislation, but Has also Legislated in the Specific Area of Partnership Taxation which this Case Involves.

Section 465 clearly and directly deals with the "at-risk" loophole which is at the core of Petitioner's concern in this case. In addition, Section 752(c) is unambiguous legislation conclusively establishing fair market value as a limit on the transactions covered by all of Section 752, which includes this case. No ambiguity exists in the language of Section 752(c); therefore, this 25 year old Congressional enactment may not be "interpreted" in a manner contrary to its clear application.

H. Differences in the Tax Treatment of Some Investors or Investments Is a Matter within Congress' Discretion.

So long as distinctions and differentiations in the taxation of particular industries or taxpayers are not constitutionally prohibited, Congress can choose to preserve them. Section 465 expressly excludes real estate from its operation. Sound taxing policies are better achieved through the process of legislative structure, integration, and hearings resulting in statutes which affect all taxpayers prospectively, rather than through a case-by-case effort to "do justice" or to avoid perceived short-term inequities.

I. Conclusion.

Respondents disposed of a profitless venture and realized only limited economic benefit upon that disposition. Therefore, they enjoyed no "amount realized" beyond the fair market value of the property securing their non-recourse note. The fact that the existing law allowed earlier depreciation deductions without economic loss does not justify the intentional misreading of the clear statutory provisions which deal with amount realized and sales of partnership interests. If a change is necessary, Congress should be required to adopt it. The Court of Appeals for the Fifth Circuit properly refused to extend *Crane v. Commissioner* beyond its specific ruling. The decision below should be affirmed.

III. ARGUMENT.

A. Position of the Parties.

Both parties claim reliance upon this Court's decision in *Crane*. Petitioner relies upon that decision to expand the statutory definition of "amount realized" under Section 1001(b) to include the full amount of non-recourse debt encumbering property when sold. Without that expansion of the statute, Petitioner is left with a Code definition of amount realized that includes only "the sum of any money received plus the fair market value of the property (other than money) received." Section 1001(b).

Respondents rely on the *Crane* decision because of the specific limitation it placed on its own expansion of that definition. That limitation is central to the proper resolution of this case. In *Crane,* non-recourse debt, which was fully covered by the fair market value of the encumbered property, was treated "as if they were his personal obligations" (331 U.S. at 14). The mortgage was included in "amount realized" "as if a personal debt in an equal amount had been assumed by another." *Id.* The Court stated in Footnote 37 that it was not ruling as to the effect of non-recourse debt which was not so "backed" by valuable collateral; "a different problem might be encountered." *Id.* Respondents conclude that *Crane* does not offer precedent for the inclusion in amount realized of non-recourse debt in excess of the fair market value of the encumbered property. Further, Respondents contend that the essential reasoning and logic of the *Crane* decision exclude such excess debt because economic benefit or "resemblance to recourse debt" is necessary in determining "amount realized".

1. *Respondents contend that the Crane decision relied on economic benefit; Petitioner argues that the Crane decision turned on the prior tax benefits enjoyed by Mrs. Crane.*

The *Crane* opinion follows two parallel lines of reasoning, economic benefit and tax benefit, in reaching its conclusion that Mrs. Crane should treat non-recourse debt as part of the "amount realized" on the sale of the property.

a. *The economic benefit concept.*

The first line of reasoning was based upon the concept that Mrs. Crane received an economic benefit equal to the amount of the mortgage transferred to the buyer, even though that mortgage was a non-recourse debt. Under the facts of *Crane,* the Court treated the non-recourse debt as if it were recourse debt, since the amount of the debt was fully secured by the value of the encumbered property.

> "We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." 331 U.S. at 14.

Under the law at that time, "personal obligations" (recourse debt) assumed or paid by a buyer was included in amount realized under the "equivalency of receipt" concept. *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716 (1929). The "resemblance to recourse debt" theory adopted by *Crane* is, in Respondents' view, the proper justification for including non-recourse debt in "amount realized" but only to the extent of the fair market value of the property. Any excess debt will not be treated by the owner of the property as a personal obligation because default would not result in the loss of any of his assets.

b. *The tax benefit concept.*

The second line of reasoning, adopted by Petitioner, is based upon *Crane's* recognition that Mrs. Crane claimed deductions for depreciation based upon a broader definition of the term "property" than she was now willing to admit. On that basis, Petitioner contends that all nonrecourse debt which was included in depreciable basis must also be included in amount realized without regard to the value of the property committed to its repayment.

2. *Timing: Respondents contend that "amount realized" is a statutory concept which is measured at the time of disposition; Petitioner argues that a seller's total involvement with the property and related liens is subject to reassessment and tax resolution through a redefinition of "amount realized".*

The propriety of the 1970 and 1971 deductions claimed by Respondents under the law as it then applied is not questioned. Petitioner's determination involved only the "amount realized" upon Respondents' 1972 "disposition" of their partnership interests.

Section 1001(b) describes money and property "received" from "the sale or other disposition of property". Respondents contend that § 1001(b) therefore refers to receipts at the time of the "sale or other disposition". Petitioner would expand the definition of "amount realized" to take into account the tax benefits enjoyed by a selling taxpayer at earlier times. Petitioner's interpretation would allow the courts to consider not only the "sum of any money received plus the fair market value of the property (other than money) received" at the time of "sale or other disposition of property," but also to consider tax advantages and, we may assume, other factors extending back through the ownership of that property and related assets[2] which may have enhanced the taxpayer's economic situation or otherwise affected his tax circumstances.

3. *The precise conflict between the parties focuses on whether amount realized should require "economic benefit" or may include recoupment based on prior "tax benefit".*

Respondents argue that "economic benefit" is essential to amount realized. This conclusion is based upon an analysis of the Code, *Crane,* and other decisions. Respondents contend that common experience and use of words indicate that amount realized requires economic benefit. Petitioner argues, to the contrary, that unless some concept of "tax benefit" is engrafted onto Section 1001(b), the result will be "the best of both worlds" (Pet.Br. 20) to those taxpayers whose property has declined in value faster than the mortgage while depreciation deductions were being enjoyed.

To support his conclusion, Petitioner postulates "a rational tax system" which cannot comprehend "contradictory assumptions". (Pet.Br. 20) If that kind of "balanced taxing system" is assumed to be a fact, there are many theories upon which one can rationalize to any desired result.

Respondents readily admit that perfect balance in the tax law would be a desirable consequence. Such balance, however, cannot be achieved through an expanded definition of amount realized nor has it been achieved by Petitioner or by Congress.[3] In fact, it may not be politically possible under our present taxing system to achieve such balance.

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[2] Since exchanged property may have a carryover basis in individual and corporate situations, it would follow that all properties to which the basis of the sold property relate would be relevant (*See,* Sections 1031, 358).

B. This Case Involves only "Amount Realized" upon the "Sale or Disposition" of Partnership Interests and not Cancellation of Indebtedness Income.

1. *Amount realized is a strictly defined statutory term.*

The appropriate statutory provision, Section 1001(b), reads as follows:

> "(b) AMOUNT REALIZED. — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *"[4]

This provision has been in the tax law since 1924 in approximately the same form as when Respondents sold their partnership interests. *See,* Appendix A-1.

A plain language reading[5] of this Section confirms its two significant elements: (1) the consideration received is measured at the time of the "sale or disposition" and not at some earlier time; and (2) proceeds of the sale are limited to material items subject to easy objective valuation such as "money" and "the fair market value of the property (other than money) received". These two elements are consistent with the stated legislative intent for Section 1001(b) which was to introduce accuracy and consistency into an area theretofore troubled with indefiniteness, difficult administration and over-restrictive IRS interpretation.[6]

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[3] *See, e.g.,* Gunn, *The Case for an Income Tax,* 1979 U. Chi. L. Rev., 370; Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an 'Ideal' Income Tax and Why They Fit Worse in a Far from Ideal World,* 31 Stan L. Rev., 831 (1979); and Bittker, *Reflections on Tax Reform,* 47 U. Cin. L. Rev., 185 (1978).

[4] It is interesting to note that nowhere in Petitioner's Brief does the actual text of Section 1001(b) appear, notwithstanding the obvious centrality of that provision to the determination of this case. Even Petitioner's paraphrase of the definition as "amount received" (Pet. Br. 9) indicates a desire to avoid the precise words of the Code. Petitioner's Appendix quotes only that portion of the Section 1001 Regulations which were amended in 1980 and adopted after the Government's initiation of this case.

[5] Statutes are to be given their plain and obvious meaning. *Crane v. Commissioner,* 331 U.S. 1 (1947); *Old Colony Railroad v. Commissioner,* 284 U.S. 552 (1932).

2. *Transfer of property for cancellation of debt does not give rise to amount realized in excess of property value.*

Petitioner argues that amounts received as loans would be taxable income but for the obligation to repay them. Therefore, he concludes, when the obligation disappears there should be some taxable event. At least two defects mar this analysis. First, there are a variety of cash receipts which are not taxable under Section 61 and which are not loans. The obligation to repay is clearly not the only reason for non-taxability.[7] In fact, a non-recourse debt does not create an "obligation to repay" any more than there is an "obligation to repay" an investment in the taxpayer's business or in his property. Since this is so, Petitioner's concern that taxpayers will "escape taxation forever on the amount of unrepaid loan proceeds" (Pet.Br. 19) does not apply when the "debt" is actually a co-investment in the purchase price of an asset rather than a cash advance. The certainty that part of a debt to purchase property will not be repaid is no more established on the day when the encumbered investment is disposed of than on some earlier day when the value of the investment has so declined as to render full payment of its acquisition cost impossible. The point is, that the purchaser of an asset is never obligated to pay its "non-recourse" price. That is an obligation which falls only on the value of the encumbered investment.

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[6] *See*, Committee Reports from the Revenue Act of 1924 quoted in the Appendix to this brief.

[7] *E.g.*, *Virginia Iron, Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939), dealt with non-taxable, non-refundable option amounts.

Second, Petitioner clearly is wrong on the law when he states an entire debt becomes amount realized even if property applied to its payment has a lesser value. In fact, the law on this point directly supports Respondents' position.

Petitioner states (Pet.Br. 18) that a debtor's transfer of property in discharge of a debt larger than the fair market value of that property will result in the full amount of the debt being treated as the "consideration received". This is not so. Petitioner's own Treasury Regulations and the cases hold that debt in excess of the value of that property is not treated as "amount realized" or as cost basis. Treasury Regulation, § 1.1017-1(b)(5), which involves cancelled debt, states:

> "(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;"

This means that only the value of the property is treated as amount realized. The excess of debt, if cancelled, is Section 61 income or can be used to reduce basis in other assets under Section 1017 if the Section 108 election is made.

In *Danenberg v. Commissioner,* 73 T.C. 370 (1979) (Acq.), the excess debt over the value of property applied against it would have been income to the debtor, but for his insolvency. *See also, Bialock v. Commissioner,* 35 T.C. 649 (1961) (Acq.).

Conversely, the courts, often at Petitioner's behest, have established the rule that the creditor who receives property in exchange for his debt has cost basis limited to the fair market value of that property, not the larger debt cancelled. *Kohn v. Commissioner,* 197 F.2d 480 (2d Cir. 1952); *Shaheen v. Commissioner,* 44 T.C.M. (CCH) 694 (1982).

In this situation, two transactions have actually occurred:

> (1) The debt has been "paid" and the property purchased to the extent of the actual fair market value of the property transferred (*Kohn, supra*); and
>
> (2) The debt has been "cancelled" to the extent it exceeds the value of the property received. *Commissioner v. Spreckels,* 120 F.2d 517 (9th Cir. 1941); Treas. Reg. § 1.1017-1(b)(5).

The tax consequences to both parties are quite different if the property transferred in payment of a debt has a value less than the discharged debt. To the extent of the value of the property transferred, the debtor has "amount realized" and may have capital gain depending on his basis. However, if the debt is higher than the property's value, the debtor would have ordinary income from debt cancellation, assuming his assets are freed up thereby. *Danenberg, supra.* Similarly, the tax effect on the creditor will vary significantly depending on the relative value of the property he accepts for his debt. His cost basis in the acquired property will be limited to its fair market value. *Kohn, supra.* He may have a bad debt deduction to the extent of any excess of debt over that value. *Spreckels, supra.*

This treatment of debt paid with property is consistent with Respondents' view of this transaction, and contrary to Petitioner's position. Had Respondents transferred an unencumbered Westwood Townhouses to a creditor in satisfaction of a $1,800,000 recourse debt, they would have "paid" that debt to the extent of $1,400,000, its fair market value. The excess amount of debt would have been ordinary income to them if it had "the effect of making the respondent's assets greater than they were before that transaction occurred". *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95, 96 (5th Cir. 1934).

C. Our Tax System Is Not Based upon an Equitable or Symmetrical System of Taxation.

It is difficult to avoid conflicting personal responses to the circumstances of this case. One feels intuitively that an investor who leaves behind a losing venture has not profited and should not be taxed. On the other hand, a taxpayer who has enjoyed tax deductions in excess of his actual economic loss will not find much sympathy. Clearly a "tax loophole" exists when taxpayers may engage in transactions with relatively little cash or economic risk and nevertheless enjoy deductions based upon a larger acquisition cost basis which has been "paid" with non-recourse debt.

Petitioner's repugnance at a tax system allowing these deductions is understandable. Although a "rational taxing system" may be a cure, particular tax results occur for reasons having nothing to do with mere revenue production. Without belaboring the point, it seems clear that the Federal Housing Authority could not have carried out its program of creating a private housing incentive to create public housing if long term federally guaranteed non-recourse loans had not been available, together with double declining balance depreciation. The imbalance of tax benefits over debt reduction was intended to be a significant economic inducement to private construction.[8] The use of tax incentives to advance political, social or foreign policy programs is still an on-going practice in our system.[9] Those who would prefer a "rational" and "perfectly balanced" taxing system would certainly prefer that direct subsidies be employed to achieve those goals. The facts, however, are otherwise. Our tax system intentionally creates asymmetrical inducements to particular social, investment or business activities which create tax advantages never to be recovered by the system. Percentage depletion deductions are not based on cost investment and are never recovered even when wells and mines are sold. The manufacturing industry is encouraged through the use of investment tax credits to replace its equipment. Industry is offered DISCs as a tax inducement to increased export sales. The lack of symmetry which these provisions create does not mean that the taxpayers who utilize them must overpay later on. The Code and Congress establish the terms upon which taxes are imposed. Explicit statutory provisions may not be ignored because symmetry appears to be preferable.

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[8] Senate Report No. 1123, 90th Congress, 2d Session 85 (1968):

> "* * * In the case of new housing units financed on a 10-percent equity – 90 percent debt basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial 10 years after the project is built. Assuming the member of the partnership is in a relatively high income tax bracket, his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capita."

[9] For example, Section 170(e)(3) was designed to allow drug manufacturers to deduct one-half of their unrealized (and untaxed) profits in addition to their cost for contributions to Cuba. The "Apple Computer" Bill now before Congress (H.R. 5573) would do the same for contributors of unsold units to public school computer programs.

D. The Non-Recourse Loophole Is a Matter of Congressional Concern.

Petitioner correctly perceives the abuse of non-recourse debt as "the allowance of a tax loss far in excess of economic loss." (Pet.Br. 24).[10] Congress has substantially closed this loophole through the enactment of "at-risk" provisions (now, Section 465). This legislative solution attacks the loophole at its source and so, is the appropriate solution of this excess loss deduction problem. Intentionally overstating "amount realized" in later years does not cure the basic fault of having allowed loss deductions which were based upon non-recourse debt.

Closing the loophole at its source is a recognition that non-recourse debt is not truly debt and should not serve as the basis for tax losses. Without stretching the analogy too precisely, non-recourse debt more closely resembles an investment in the nature of preferred stock, which pays a "dividend" (denominated as interest) and is recoverable only out of the investment. Borrowers, like common stockholders, enjoy all investment appreciation, while lenders, like preferred shareholders, share economic risk.[11] Eco-

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[10] Petitioner objects to the allowance of deductions in excess of any monetary outlay or other actual economic loss. Pet.Br. 22. This problem is corrected by disallowing the losses not by overinflating amount realized.

[11] Petitioner seems to agree with this analysis when he writes:

> "Indeed, it is the lender, not the taxpayer, who may bear the economic and tax loss attributable to the decline in value of

nomically, non-recourse obligations are not true debt at all. No one owes the debt or has promised to repay it.

Congressional enactment of Section 465 in 1976 and as amended in 1978 confirms the conclusion that non-recourse debt will not support a tax loss. This solution to excess deductions is a matter of legislative choice, as is the exemption of real estate from Section 465. Congress' decision to disallow losses at the beginning, rather than amending Section 1001(b) to include the language which Petitioner inserted into the Regulations[12] in 1980, must be honored. Congress has recognized correctly that the evil to be attacked is the excessive deductions created by non-recourse debt and not the 52-year-old definition of "amount realized".

Petitioner contends that this Court should close the non-recourse loophole by expanding Section 1001(b) because Congress has not seen fit to do so. Respondents contend to the contrary, for exactly the same reason.

> the property in these circumstances. But under the court of appeals' decision, respondents are permitted to claim a tax loss equal to the lender's potential economic loss." (Pet.Br. 24).

Petitioner errs in stating that the Court of Appeals' decision below allows taxpayers to deduct any part of the loss. In fact, the Court of Appeals never addressed this issue.

[12] Congress could have chosen to add this language to the Code, but did not do so.

> "Reg. § 1.1001-2. Discharge of Liabilities.
> (a) *Inclusion in amount realized* – (1) *In general.* Except as provided in paragraph (a) (2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

E. Economic Benefit Is the Proper Test of Amount Realized.

The literal provisions of Section 1001(b) clearly speak in terms of "economic benefit". The "sum of any money received and other property (other than money) received" are items of present material benefit, received at the time of disposition or sale. In addition to these obvious statutory terms, the "economic benefit" standard is confirmed from a legal and a logical point of view.

1. *The economic benefit concept was central and essential to the Crane decision.*

Before *Crane,* amount realized included assumed or paid recourse debt,[13] but no clear authority existed for taxing gain to a seller who was not liable on his property's purchase money debt.[14] In 1944, the Tax Court confirmed that state of the law in *Beulah B. Crane v. Commissioner,* 3 T.C. 585 (1944). Judge Tyson, in agreeing with Mrs. Crane, stated:

> "***As she was never under any personal obligation to pay the mortgage debt she received no consideration whatever when she sold and conveyed the property subject to the mortgage, except the $2,500 in money mentioned above." 3 T.C. at 590.

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[13] *See, Crane, supra.* at 13. n 34.

[14] *Lutz & Schramm Co. v. Commissioner,* 1 T.C. 682 (1943), did treat non-recourse debt as amount realized, but the money had been borrowed in the year after the property's acquisition. "We therefore conclude that the petitioner borrowed the money from Crawford and *used it for its own purpose and benefit.*" (Emphasis supplied.) 1 T.C. at 688. In *Charles L. Nutter v. Commissioner,* 7 T.C. 480 (1946), the Tax Court held no amount realized where a purchase money loan was involved. *Lutz & Schramm Co.* was distinguished as a "cash-out" case.

The Second Circuit Court of Appeals reversed on the ground that the transaction more closely resembled a payment of the full purchase price to Mrs. Crane "on condition that before he took title the lien should be cleared." (153 F.2d 504, 506 (2d Cir. 1947). Judge Hand observed that since Mrs. Crane decided to sell the property rather than abandon it she had continued the venture. The consequence of abandonment subject to non-recourse debt would have been no gain at all.[15]

In affirming the Circuit Court in 1947, this Court's decision involved a three-part analysis:

> (1) "The property" was identified. The Court determined that the asset inherited was the "total property", not merely Mrs. Crane's equity.
>
> (2) "Basis" followed right along on the theory that the inherited "total property" had a fair market value which established its basis at death unreduced by secured non-recourse debt.[16]

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[15] "To this the taxpayer answers that the result may be, as it was here, to subject the mortgagor to a tax upon a gain which is out of all proportion to what he in fact receives; to a tax which may indeed be greater than the whole consideration received. That is true, but it is the consequence of his continuing in a venture from which he is free to retire whenever he concludes that all opportunity for gain has ended. He is not charged with gain except upon a 'sale or other disposition' of the property – § 111(a) – and if he abandons it to the mortgagee there is no gain." *Crane v. Commissioner*, 153 F.2d 504, 506 (2d Cir. 1945).

[16] In *Peter Vaira v. Commissioner*, 52 T.C. 986 (1969) *rev'd on other grounds*, 444 F.2d 770 (3d Cir. 1971) Judge Tannewald observed that this conclusion as to basis assumed the value of the property exceeded its lien:

> "This is a valid conclusion at least where the amount of the encumbrance is not in excess of the date-of-death value of the property. The Supreme Court left open the question as to what

(3) Therefore, the Court concluded, "amount realized" on the sale must, to avoid an "absurdity", be similarly tied to the "total property". So long as the non-recourse mortgage is "a figure less than that at which the property will sell" (331. U.S. at 14), it should be included in "amount realized."

Analysis of the *Crane* decision is much like identifying an elephant while blindfolded. A number of phrases have been extracted from the opinion which are claimed to represent its core.

For example, the phrase "functional relation" is used by the Court to describe the fact that the "property" purchased is the same as the "property" sold. Since the determination of gain on sale is a function of "amount realized" reduced by "basis", those two terms certainly should describe the same "property". The "functional relation" of the two sections requires that the word mean the same in one section that it does in another (331 U.S. at 12). That does not mean that "basis" and "amount realized" "move together". It only means that "property" should have the same definition in either context. Nevertheless, that phrase has been employed by Petitioner to support his claim that non-recourse debt included in basis must also be included in amount realized. (Pet.Br. 34). Actually, in Mrs. Crane's situation, the non-recourse debt was not "included" in her basis at all. Her basis was determined by the fair market value of the property at death, with no reference to the debt.

The "double deduction" phrase in *Crane* appears to be a reference to (1) the depreciation deductions allowed dur-

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the rule would be if the amount of the encumbrance was greater. *See* 331 U.S. at 12. Compare *Parker v. Delaney*, 186 F.2d 455, 458 (C.A. 1, 1950)." *Id.*, at 996 n. 6.

ing her ownership of the property, and (2) the reduction of gain which would result if her basis were not reduced by these depreciation deductions. The Fifth Circuit Court of Appeals concluded that no improper tax result occurs when the depreciation deduction is in fact confirmed by a corresponding reduction in the value of the property depreciated. In fact, the first deduction is negated if recapture is required without value to support it. *Tufts,* 651 F.2d at 1061. The *Crane* Court's reference was strictly in response to Mrs. Crane's constitutional argument, rather than an effort to identify two deductions. Simmons, *Tufts v. Commissioner: Amount Realized Limited to Fair Market Value,* 15 U. C. Davis L. Rev. 577, 591-92 (1980).

If a property purchased for cash actually declined in value according to its depreciation deductions, the seller would not be expected to "realize" the amounts previously taken as depreciation deductions where the price paid reflects only the property's current reduced value. Certainly, the existence of a mortgage should not change that result.

Crane turned on its realistic conclusion that the owner of property which is valued higher than the non-recourse debt which it secures would treat that debt as a personal obligation. Therefore, whether that value is paid directly to the seller or the property is transferred subject to that debt, "[i]n either case the taxpayer realized an economic benefit". *Diedrich v. Commissioner,* ___ U.S. ___, 102 S.Ct. 2414, 2418 (1982). When one disposes of property subject to a nonrecourse debt in an amount greater than the encumbered property's value, he realizes "economic benefit", but only to the extent of that value.

Crane's Footnote 37 was additional emphasis which the Court placed on the importance of economic benefit to amount realized.[17] Cox, *Nonrecourse Mortgage Indebtedness as Amount Realized: Footnote 37 Revisited*, 33 Sw. L.J. 1257 (1980).

2. *Congress and the IRS have agreed that economic benefit, fair market value and economic substance are critical in determining tax consequences.*

Section 752(c) provides as follows:

> "(c) LIABILITIES TO WHICH PROPERTY IS SUBJECT.—For purposes of this section, a liability to which property is subject [non-recourse] shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." (Bracketed words added.)

It is widely acknowledged that Section 752 reflects a legislative enactment of the "*Crane* doctrine." Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public,* 27 Tax L. Rev. 525, 542 (1972). To the extent fair market value is a significant factor in that section, Footnote 37 of *Crane* must be its source. In no other place is fair market value discussed in *Crane*.

Similarly, Section 311(c) has this provision:

> "* * * In the case of a distribution of property *subject to* a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preced-

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[17] "[37]Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case." *Crane v. Commissioner*, 331 U.S. 1, 14 n. 37 (1947).

> ing sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis." (Emphasis supplied.)

Once again, Congress recognized that the value of the property securing a larger non-recourse debt is a limit on "amount realized."

For tax years beginning in 1981, Congress has enacted directly into the Code the provision that no income results from the cancellation of an indebtedness of an insolvent taxpayer. Section 108(a)(1)(B), as amended by the Bankruptcy Tax Act of 1980, Public Law No. 96-589, § 2(a), 94 Stat. 3389 (1980). This is consistent with the established principle that cancelled debts create no income except to the extent assets are "freed from claims of creditors." *Haden Co. v. Commissioner,* 118 F.2d 285, 286 (5th Cir. 1941).

A non-recourse mortgage in the estate of a deceased may not be deducted as a debt of the decedent to the extent the mortgage exceeds the fair value of the encumbered property. *See,* Treas. Reg. § 20.2053-7; Instructions for Form 706, United States Estate Tax Return, at 14-15 (Rev. June 1982). Thus, Congress and Petitioner have recognized the limiting factor which the fair market value of collateral places on our system of taxation and recognition of gain.

3. *Courts recognize the importance of value and economic substance in deciding tax consequences.*

The most significant recent cases reconfirming the "economic benefit" rationale of *Crane* involve the buyer's side of that same kind of transaction. Would Mr. Tufts' purchaser, Mr. Bayles, have been allowed to treat as "cost basis" the full amount of mortgage debt which greatly exceeded the fair market value of the property? Petitioner has been successful in denying cost basis where the stated price and non-recourse debt are in excess of the fair market value of the property. In *Estate of Franklin v. Commissioner,* 544 F.2d 1045 (9th Cir. 1976), Petitioner successfully limited a purchaser's cost basis in property to its fair market value notwithstanding a much higher stated purchase price and a non-recourse note evidencing that price. That conclusion has been reconfirmed in a number of cases. *E.g., Hilton v. Commissioner,* 671 F.2d 316 (9th Cir. 1982); *Siegel v. Commissioner,* 78 T.C. 685 (1982); *Brannen v. Commissioner,* 78 T.C. 574 (1982).[18]

It is difficult to justify as "rationale" a tax system in which the sellers of property subject to non-recourse debt must treat the full debt as amount realized while the purchaser may not claim any cost basis in excess of the property's fair market value. Yet, that is exactly Petitioner's contention here. This inconsistency cannot be reconciled. If there is a "functional relation" anywhere in the tax law, it must be between the amount realized on the sale of a particular property and the cost basis to the purchaser of that same property.

The importance of "actual benefit" and "objective economic realities" in the application of our tax laws cannot be overstated. *See, Frank Lyon Co. v. United States,* 435 U.S. 561, 572-73 (1978). Income from debt cancellation, for example, is clearly limited to the economic benefit enjoyed by the debtor. If he is not raised above insolvency, thereby "acquiring something of exchangeable value in addition to what he had before." [Revenue Ruling 58-600, 1958-2 C.B. 29, quoting from *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95 (5th Cir. 1934)], there is no taxable income. There must be a genuine economic effect to convert debt cancellation into income. *Carl T. Miller Trust v. Commissioner,* 76 T.C. 191, 201 (1981); *Texas Gas Distributing Co. v. Commissioner,* 3 T.C. 57 (1944) (Acq.)

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[18] Revenue Ruling 80-42 (1980-1 C.B. 182) and Revenue Ruling 77-110 (1977-1 C.B. 58) similarly held that motion picture exhibition rights purchased for notes in excess of fair market value do not create cost basis. The reasoning of these revenue rulings is that when a property's fair market value is less than the non-recourse note, there is no longer the incentive to treat the property as your own, as pointed out in the Crane case. These IRS interpretations of *Crane* are obviously based on the "economic benefit" aspect of *Crane*.

Loans without economic substance will not support interest deductions. *See, Knetsch v. United States,* 364 U.S. 361 (1960); *Goodstein v. Commissioner,* 267 F.2d 127 (1st Cir. 1959). Mere title to property without true economic risk will not support deductions purporting to measure true economic loss. *See, Royal St. Louis, Inc., v. United States,* 578 F.2d 1017 (5th Cir. 1978). Ownership of the "tree" is essential to taxability; separation of the "fruit" does not separate income from its earner. *See, Helvering v. Horst,* 311 U.S. 112 (1940). The transfer of property in satisfaction of a debt greater than the property's value results in the debtor realizing no more than the value of the transferred property. Any excess debt is taxable to the debtor only if the cancellation of indebtedness rules apply.

In this very case, Petitioner acknowledges the importance of true economic loss in determining deductible tax losses. He rejects the possibility that a person may "claim a tax loss in excess of his actual economic loss." (Pet.Br. 23) Gain is but the other side of the same coin.

In the absence of enhanced financial or economic condition either through the acquisition of valuable assets or the reduction of true debt, there is no "amount realized". "[A]ccessions to wealth, clearly realized" are income. *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 431 (1955).

In one of its early examinations of the nature of income, this Court ruled that a transaction which resulted in an overall loss would not be treated as creating taxable income even though profit was demonstrable on an isolated aspect of the transaction. In *Bowers v. Kerbaugh-Empire Co.,* 271 U.S. 170 (1926), this Court held that the devaluation of the German mark did not result in gain to an obligor on a note payable in marks.

> "The contention that the item in question is cash gain disregards the fact that the borrowed money was lost, and that the excess of such loss over income was more than the amount borrowed. When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit or income." 271 U.S. at 175.

4. *Post-Crane cases.*

Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950) is consistent with Respondents' view of the law. That case supports the economic benefit and fair market value limitation of *Crane,* but had no evidence before it to make an appropriate finding of value. The court relied on the *Crane* decision for the proposition that disposition of property to the mortgage lender is taxable "so long as the value of the properties was not less than the liens." (186 F.2d at 458) In *Crane,* the Court found that value as demonstrated by the $3,000 "boot" paid to Mrs. Crane; no such evidence of value was submitted to the *Parker* court.

On the other hand, the recent case of *Millar v. Commissioner*, 577 F.2d 212 (3d Cir.), *cert. denied* 439 U.S. 1046 (1978), is clearly irreconcilable with Respondents' view of the law.

Millar v. Commissioner involved a contrived tax avoidance scheme which is no longer possible. Congress has already solved the *Millar* problem, but in a totally different way than the Tax Court. The taxpayers were relatives and/or close business associates of a coal mine operator who gave them Subchapter S corporation stock and contributed $500,000 of corporate working capital. They signed non-recourse notes secured by the stock. The corporate mining losses absorbed the working capital and dropped the basis and value of the stock to zero. The shareholders returned their stock to the operator, paying nothing on the notes. The corporation went into bankruptcy. The Commissioner did not challenge the deductibility of Subchapter S losses enjoyed by each shareholder, but successfully contended that the face amount of their notes constituted "amount realized."[19]

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[19] Taxpayers contended that the cash received from the operator was intended as a gift and not a loan so that no "amount realized" could occur. They alternatively argued that Footnote 37 limited the amount realized to the value of their stock. Judge Quealy, however, ruled that it was not necessary to make such a distinction and held that the taxpayers had long-term capital gain of the full amount plus penalties for negligence. 34 T.C.M. 554 (1975). On appeal, Chief Judge Seitz observed that it would be impossible to determine that gain was realized if the operator's advances had been gifts. He also observed that the Tax Court had entirely failed to consider the *Crane* issue. He vacated the decision and remanded to the Tax Court for further determination. 540 F.2d 184 (3d Cir. 1976).

On remand, Judge Quealy concluded that of course a loan had been made: "In the absence of any proof to the contrary, the transaction speaks for itself." 67 T.C. 656, 658 (1977). On the *Crane* Footnote 37 issue, he observed:

Section 465 now denies tax losses to Subchapter S shareholders whose investment is based on non-recourse debt.[20]

"In our opinion, the value of the stock was immaterial. Petitioners had received a cash equivalent in the amount of the notes, whether they were personally liable on such notes or not. *Parker v. Delaney, supra; Mendham Corp., supra.* Unlike the Court of Appeals, this Court would not, however, conclude that the stock was 'worthless' when it was surrendered to Mr. Jamison. It had a value to Mr. Jamison, particularly since as sole stockholder he would be able to deduct the anticipated losses which would be incurred in winding up the affairs of the corporation. The transaction amounted to more than the acquisition by foreclosure of a worthless piece of paper." 67 T.C. at 660-61.

On review before an entirely new panel, the opinion of the Tax Court was essentially affirmed without the thoughtful analysis offered by Judge Seitz. 577 F.2d 212 (3d Cir. 1978), *cert denied*, 439 U.S. 1046 (1978).

[20] Treasury Regulations § 1.465-10 (Proposed, June 5, 1979):

"§ 1.465-10. General rules; rules relating to subchapter S corporations and their shareholders. – (a) In general. In the case of electing small business corporations (as defined in section 1371 (b)) the at risk rules of section 465 apply at both the corporate level and the shareholder level. Therefore, losses from an activity can be deducted by the corporation only to the extent that the corporation is at risk in the activity. In addition, each shareholder will be allowed a loss in the activity only to the extent that the shareholder is at risk in the activity."

Adopting the Petitioner's definition of amount realized would actually result in the allowance of non-recourse losses. This incongruous result can best be demonstrated by analyzing the facts of *Millar* under present law and specifically § 465.

Assume the shareholder in a Subchapter S corporation borrows $1,000 on a non-recourse basis, pledges the stock as collateral, and contributes those monies to the corporation. During its first year, 1981, the corporation sustains a $1,000 loss. During 1982, This approach deals with the problem where it lies: denying deductions which do not reflect economic loss. It does not "manufacture" an amount realized in a totally vacuous series of paper transactions like *Millar*.

It is particularly significant that the applicable Section 465 Treasury Regulations actually adopt a "Footnote 37" approach in establishing the tax effect of a partially secured non-recourse note. The "at-risk" portion of such a note is limited precisely to the "net fair market value" of "uninvolved" property securing it. Treas. Regs. §1.465-25. This is precisely the "economic benefit" rationale of *Crane* and Respondents' position here.

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the shareholder disposes of his stock subject to the $1,000 nonrecourse debt at a time when the value of the stock is zero. Because of § 465, the shareholder was not entitled to deduct the 1981 loss which was allocated to him. Nevertheless, the shareholder's basis in his stock was reduced by the full $1,000. Section 1376(b). The shareholder could utilize the loss during 1982 to the extent he recognized gain on the disposition of his stock. Proposed Reg. § 1.465-12(a) provides that a taxpayer becomes "at risk" to the extent of income from the activity. Income received or accrued from an activity *includes* gain recognized upon the disposition of the activity or an interest in the activity. Under Petitioner's definition of amount realized, the shareholder would have an amount realized of $1,000, a capital gain of $1,000, and would, therefore, be able to utilize the $1,000 loss in 1982, despite the fact that the shareholder was never economically at risk in the activity. Under Respondent's definition of amount realized, the shareholder would have no amount realized and therefore no amount of gain. Therefore, shareholder would not be allowed to utilize the loss which was denied to him under Section 465 because he was never economically at risk in the activity.

F. The Sale of Partnership Interests Is Governed by Specific Code Provisions which Reconfirm the Economic Benefit Concept.

This case involves a somewhat unusual fact situation in that the "properties" sold by the Respondents were partnership interests. The partnership in turn owned the Westwood Townhouses project and was the actual signator on loan documents creating the non-recourse debt.

1. *Section 752(d) specifically covers this transaction.*

There is no legislative history explaining the addition of Section 752(d) in the overall revision of the partnership tax provisions in 1954. Nevertheless, the clear words of that provision unquestionably describe the transaction involved here:

> "Section 752(d) SALE OR EXCHANGE OF AN INTEREST — In the case of the sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."

Petitioners' position on Section 752 is not entirely clear (Pet.Br. 46-47). He seems to agree that our transaction is described in Section 752(d), but bootstraps to the conclusion that since no difference should exist between the tax consequences of selling a partnership interest and any other property, Section 752(d) is of no effect. He would conclude both kinds of sales are governed by the *Crane* rule. Obviously, *Crane* would not apply precisely to this situation because the partnership interests themselves were not "subject to any liability". If Petitioner's interpretation of Section 752(d) is correct, the sale of a partnership interest which is not separately mortgaged would create no "amount realized" in excess of the cash consideration received. Only through an application of Section 752(b) (decrease in a partner's share of partnership liabilities is treated as cash distributed) could the partnership's liabilities even be remotely considered as part of the "amount realized" by a partner on the sale of his interest in the partnership.

Notwithstanding this available argument, Respondents believe that a more appropriate reading of Section 752(d) is to treat it as part of Subchapter K and more particularly as a part of Section 752 for all purposes, including Section 752(c).

2. *Section 752(c) explicitly limits non-recourse liability to the value of the encumbered property.*

Section 752(c) with its fair market value limitation seems to be the legislative enactment of *Crane*. It should apply to this case. As the Tax Court below agreed, "the language of Section 752(c) is broad enough to support the (Respondents') interpretation." (70 T.C. at 768). That section says:

> "Section 752(c) LIABILITY TO WHICH PROPERTY IS SUBJECT. — For purposes of this Section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property."

As the introduction to Section 752(c) states, that Section clearly applies for *all* purposes of Section 752, including Section 752(d). Despite this unambiguous statement, Petitioner claims that Section 752(c) should be interpreted by resort to legislative history (Pet.Br. 46). Since rules of construction are intended to assist in the search for legislative intent, those rules have no function where there is no ambiguity. *United States v. American Trucking Associations, Inc.*, 310 U.S. 534 (1940). *See, Burnet v. Guggenheim*, 288 U.S. 280 (1933). The particular legislative history of

Section 752(c) does not purport to limit the applicability of that Section, but only gives examples in which the Section would most obviously apply. *See*, S. Rep. No. 1622, 83d Cong., 2d Sess. 405 (1954). These examples, however, do not claim to limit the applicability of that Section.

The effect of Section 752(c) as applied to this case is to treat the Westwood Townhouses partnership as "liable for" $1,400,000 of mortgage debt. Therefore, on sale of partnership interests by the partners, the "amount realized" would be limited to $1,400,000, which is consistent with the *Crane* concept that amount realized includes nonrecourse debt but only to the extent of the fair market value of the encumbered property securing it.

G. Congress, not the Courts, Should Legislate Amendments to the Internal Revenue Code.

> "The answer is that we must apply the statute as we find it, leaving to Congress the correction of asserted inconsistencies and any inequalities in its operation." *McClain v. Commissioner*, 311 U.S. 527, 530 (1941).

The Tax Court in dealing with the widest range of tax laws has stated:

> "It is not the function of a Court to rewrite or amend a statute in the guise of construing it. It is the Court's duty to construe and apply the statute as it is written; and if this results in inequity to certain taxpayers, the fault lies in the statute itself and is beyond the power of the Court to correct." *David Metzger Trust v. Commissioner*, 76 T.C. 42, 59-60 (1981).

This Court has agreed that it should not rewrite statutes even if it feels that the scheme Congress created can be improved. *United States v. Calamaro*, 354 U.S. 351, 357 (1957).

> "After all, Congress expresses its purpose by words. It is for us to ascertain — neither to add nor to subtract, neither to delete nor to distort." *62 Cases of Jam v. United States*, 340 U.S. 593, 596 (1951).

1. *Sound tax policy should be based upon integrated legislative practices and not upon case by case decisions.*

Although Congressional intention may be generally perceived, if the language of the statute does not carry that intention into words, "the provisions of such acts are not to be extended by implication." *Smietanka v. First Trust & Savings Bank*, 257 U.S. 602, 606 (1922).

Courts are lobbied continuously by contesting attorneys claiming that justice and fairness is on their side. The outcome of these cases, however, generally is not projected beyond the facts before the bar. This practice in the area of taxation creates unnecessarily unforseeable circumstances.[21]

This period of tax shelter abuse is a particularly difficult one for objective judgments where it appears that unfair advantage is being taken of the system. Congress acted decisively in this area through the Tax Reform Act of 1976. But even that Act specifically sought only to "eliminate the abuses associated with tax shelter *to the extent appropriate in view of their economic impact.*" (Emphasis supplied.) Senate Report No. 938, 94th Cong. 2d Sess. Part I, 9 (1976).

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[21] Judicial attempts at legislation often produce results not intended by Congress. For example, The Tax Equity and Fiscal Responsibility Bill of 1982 specifically overruled *Rickey v. United States*, 592 F.2d 1251 (5th Cir. 1979), a case that interpreted Section 318 contrary to its plain meaning. *See also, United States v. Hendler*, 303 U.S. 564 (1938) (interpretation of predecessor to Section 368(a)(1)(C) advanced by Government overturned by Congress).

We are all aware of the damage being done to our taxing system by abusive tax shelters and their promoters.[22] However, we should not allow the difficulties and pressures of these times to distort a far-sighted view of statutory interpretation which must survive beyond this case. It should be recognized that an elected legislature is the better forum for changes in the law, even though apparent emergencies seem to demand faster response.

National policy affecting revenue collection, whether it involves energy production, housing construction or international trade, is a matter properly within the exclusive scope of Congress. Judicial intervention is clearly unavoidable in many circumstances; however, the long established principles which limit judicial reinterpretation of clear and unambiguous statutes should be carefully observed in an emotionally charged case like this one. *See, Iselin v. United States,* 270 U.S. 245 (1926); *LaBelle Iron Works v. United States,* 256 U.S. 377 (1921); *Brushaber v. Union Pac. R.R.,* 240 U.S. 1 (1916).

2. *Perceived Loopholes Must Be Closed by Congress.*

Unquestionably, the application of the Internal Revenue Code may create unexpected and perhaps undesirable tax solutions which may be referred to as "loopholes". The Courts, however, have consistently ruled that "if the facts of this case demonstrate a tax loophole, Congress, not the Courts, should plug it in." *See, Manufacturers Hanover Trust Co. v. Commissioner,* 431 F.2d 664, 668 (2d Cir. 1970); *Davis v. Commissioner,* 491 F.2d 709, 710 (6th Cir. 1974). *Leathers v. United States,* 471 F.2d 856 (8th Cir. 1972), *cert. denied* 412 U.S. 932 (1973).

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[22] Although it should have no effect on its outcome, the case at bar does not involve a tax shelter promotion or a professional shelter promoter. Westwood Townhouses was conceived by Clark Pelt, a builder in Duncanville, Texas, and was largely financed by his money and that of his corporation. In order to have qualified guarantors available for his interim financing, he invited relatives and friends in the Duncanville area to share ownership with him. They joined for no reason other than investment potential. When they finally got out of this losing venture, they disclosed fully all aspects of the transaction on their tax returns. *See,* factual statements below, *Tufts v. Commissioner,* 70 T.C. 756, 758-761.

Actually, some "loopholes" come from judicial efforts to resolve conflicts. It was, after all, the Government's victory in *Crane* which "laid the foundation stone of most tax shelters." *See,* Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case,* 33 Tax L. Rev. 277, 283 (1978).

H. Petitioner's Tax Benefit Concept Is a Rationalization for the Unsound Conclusion that Tax Benefits once Enjoyed Must Be "Recaptured".

Many knowledgeable and sincere tax scholars have taken issue with the potential unfairness of a taxing system which allows deductions based on non-recourse debt and then limits the amount realized to the actual economic benefit enjoyed by the taxpayer on disposition of his property. Their concern is based on the concept that if these deductions are allowed, there is an "escape from taxation" if they are not subsequently recaptured as income. There is, however, no taxing principle or rule of law that deductions taken earlier must be later recovered as income or gain. In the absence of specific legislation providing for "recapture" (*See, e.g.* Sections 47, 111, 1245, 1250), such a result is not countenanced by judicial act.

The true source of this concern is the blatancy of tax shelters which promise deductions to taxpayers far beyond true economic risk. Congress must solve that problem by changing the laws which allow it. The Courts should not "find" legal solutions where none exist.

1. *The law does not require that tax benefits be "recaptured".*

If a taxpayer drilled a successful oil well in 1930 and in the next 50 years recovered not only his costs but also $15,000,000 in oil runs and in 1980 sold the depleted and fully depreciated oil property for $1,000, he would pay tax on $1,000 of gain.[23] Even though he might have been allowed $3,000,000 in percentage depletion deductions after recovery of his entire cash investment, our tax system does not require that these tax deductions be "recaptured".

If that same taxpayer borrowed $10,000,000 in 1980 and used it to drill additional oil wells, he might be entitled to deduct most of those costs as intangible drilling expenses and thereby offset $10,000,000 of other income. Section 263(c). He could save $5,000,000 in taxes. But if, in the following year, his oil empire collapsed, he was insolvent, and all of his debts were cancelled, he would have no taxable income, even though he had enjoyed $10,000,000 in investment and $5,000,000 of additional tax savings. *See,* Revenue Ruling 58-600, 1958-2 C.B. 29. There is no requirement that taxpayers "refund" tax benefits earlier enjoyed.

A trust or estate may distribute appreciated property to a beneficiary and claim a deduction for that full value as a "distribution deduction".[24] As a result, the trust pays no tax on the appreciation. The beneficiaries report the distribution as income but will have full cost basis in the asset. As a result, no one will ever pay a tax on the appreciation in that property. Contributions to charity of appreciated capital assets enjoy a similar advantage. *See,* Section 170(e)(1).

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[23] Revenue Ruling 75-451, 1975-2 C.B. 330, ruled that gain in such a situation is limited to the excess of the selling price over an adjusted basis of zero.

[24] Trautman, *The Income Taxation of Estate Distributions — A Need for Reform*, 44 Indiana Law J. 397 (1969).

There is no requirement in any of these situations, and many more which could be listed, that our taxing system create a perfect balance between allowable tax deductions and offsetting tax detriments.

2. *If the assumption of a balanced tax system were sound, innumerable rationalizations could be created to legalistically support any conclusion.*

It would take no more than one or two professors, philosophers or authors to develop a selection of theories upon which any of these "schemes" could be demonstrated as improper if the premise that our taxation system must "balance" is accepted.

For example "amount realized" could be rationalized to include oil and gas depletion on the theory that depletion is based on capital "on loan" from nature or from the United States Treasury which loan must now be "repaid" since the transaction is closed without replacement of that capital or loan.

Despite the insolvency of a borrower unable to repay the prior receipt and enjoyment of cash, a theory could be developed to support "total transaction" gain if balance in the tax system were necessary. The need for a balancing accounting entry could be the justification for such a result.

A rationalization could be developed to tax a trust which uses appreciated property to distribute income to a beneficiary. The trust's distribution "obligation" could be construed as a liquidated obligation and the transaction could be treated as a "sale" by the trust and a distribution of cash to the beneficiary who then purchases the same asset.

These examples are only intended as illustrations of the ease with which some theory of taxation can always be developed to support an assumed conclusion.

3. *A tax benefit approach to amount realized results in unpredictability, inconsistentency and unfairness.*

Mrs. Crane asked, "What if I inherited unimproved property when it was worth *less* than the non-recourse mortgage encumbering it but decided to hold it in hope of future appreciation? If I later disposed of the property when its value was still less than the mortgage, would I be taxable on the excess of mortgage debt over my basis? There was clearly no profit to me, nor tax benefit."

Although *Crane* refused to answer this kind of question, (331 U.S. at 15, n. 42), Petitioner seemingly would conclude that since the debt is included in basis to the extent of value, only that amount of debt would be included in amount realized. (*See,* Treas. Reg. § 1.1001-2(a)(3)).

The problem with Petitioner's Regulation and his solution is that true gain will not be taxed. For example, Mr. Bayles, who purchased the Westwood Townhouses partnership from Mr. Tufts, et al, would have been allowed a cost basis of only $1,400,000 (its actual value at the date of purchase) under the theory of *Estate of Franklin, supra.* If, at the end of the next two years he disposed of the property when its value appreciated to $1,750,000, and was still subject to a mortgage of $1,800,000, would he be taxable on that additional $350,000 of value? Apparently, Petitioner would say "no" since that amount was not included in his basis. Gain would be limited to any depreciation taken during the interim. However, under the *Estate of Franklin* rule, the buyer *from* Mr. Bayles would be entitled to a cost basis of $1,750,000! How would Petitioner's "rational tax system" treat the loss of revenues incident to the additional $350,000 of basis which the new buyer *will be entitled to claim* while Mr. Bayles realized no taxable profit?

Obviously, Petitioner will have to amend his Regulations to cure this anomaly and will doubtless have other situations arise which would require corrective action. Congress should be solicited to make these changes, not the courts.

Respondents' approach, which includes the $350,000 in amount realized, is more reflective of economic reality and is more predictable in this kind of situation. Genuine negotiation would occur between buyer and seller as to the fair market value of the property. The buyer would recognize that his basis would be limited to that value; he would know that any appreciation would constitute gain on his subsequent disposition of the property. The seller, on the other hand, would negotiate for the lowest value possible. These adverse economic negotiating positions are consistent with achieving realistic tax results. Therefore, if rents had so appreciated as to justify a valuation of the property at $1,750,000, Mr. Bayles could be expected to have a new economic decision to make; whether to sell and realize the gain, measured by the "value of the property", or hold it for rents or future appreciation. In any event, the Federal revenues would not suffer through these transactions.[25]

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[25] Another obvious illustration of the fallacy of Petitioner's tax benefit theory arises when allowable deductions do not benefit the taxpayer. For example, a taxpayer with no taxable income inherits depreciable property encumbered by a non-recourse mortgage equal to the value of the property. Because the taxpayer has no taxable income, he cannot utilize the depreciation deductions. Nevertheless, the basis of the property must be reduced by "al-

4. *Summary.*

Petitioner's argument is based on a desire to "recapture" tax deductions based on non-recourse debt without regard to actual tax benefits, without regard to economic benefits, and without regard to the language of the Internal Revenue Code. Our tax system, however, does not require and is not based upon the concept that deductions previously taken must be recaptured, notwithstanding the apparent unfairness of such an arrangement. In the absence of true economic gain, the "tax benefit" concept cannot be subverted to create income where none exists. *Nash v. United States,* 398 U.S. 1 (1970). Recapture is a matter of Congressional, not judicial, concern.

Congress knows very well how to legislate tax benefit recaptures. For example, Section 111 deals with recognition of income on recovered debts previously deducted depending on whether earlier tax benefits can be established; actual recovery of the debt is essential. Sections 1245 and 1250 recharacterize gains as ordinary income, but only under specific circumstances and then only to the extent of the gain. Section 47 recaptures investment credit on early disposition without the necessity of gain. Section 465 also has its own recapture provision (§ 465(e)) if the amount "at-risk" in a particular activity falls below zero. All of these enactments followed clear legislative procedures and were in response to Treasury requests. It was

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lowable" as well as "allowed" depreciation deductions. Section 1016(a)(2). When property actually has declined in value and the mortgage is unchanged, the taxpayer disposes of the property subject to the debt. In this situation, notwithstanding the total absence of any tax advantage, Petitioner's theory would require recognition of gain without economic benefit, without tax benefit, and without any semblance of fairness. Certainly, Respondent's theory provides a more rational result.

not necessary for the courts to interfere to correct the potential of tax escape. That is Congress' job. It has done so by focusing on "economics"; economic loss and "at-risk" is necessary for deductions; economic benefit is the correct basis for measuring amount realized.

I. Conclusion.

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

Ronald M. Mankoff

Charles D. Pulman

October, 1982

APPENDIX

Sec. 202(c), Revenue Act of 1924, 43 Stat. 253: [DETERMINATION OF AMOUNT OF GAIN OR LOSS.]

"(c) The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

COMMITTEE REPORTS

REPORT, — WAYS AND MEANS COMMITTEE (68th CONG., 1st SESS., H. REPT. 179): "(3) Subdivision (c) does not correspond to any provision of the existing law but embodies in that law what is the correct construction of the existing law; that is, that where income is realized in the form of property, the measure of the income is the fair market value of the property at the date of its receipt. (p. 13)

* * *

The existing law provides, in Section 202(c), that no gain or loss is recognized (that is, considered for the purpose of determining taxable income) from an exchange of property unless the property received in exchange has a realizable market value.

* * *

The provision is so indefinite that it can not be applied with accuracy, nor with consistency." *Id.* at 13.

REPORT — SENATE FINANCE COMMITTEE (68th CONG., 1st SESS., S. REPT. 398): "(3) Subdivision (c) does not correspond to any provision of the existing law but embodies in the law what is and has always been the construction of the law adopted by the department and by the courts; that is, that where income is realized in the form of property the measure of the income is the fair market value of the property at the date of its receipt.

* * *

Section 203: The existing law provides, in section 202(c), that no gain or loss is recognized from an exchange of property unless the property received in exchange has a readily realizable market value. Great difficulty has been experienced in administering this provision. The question whether, in a given case, the property received in exchange has a readily realizable market value is a most difficult one, and the rulings on this question in given cases have been far from satisfactory. Furthermore, the construction placed upon the term by the department has restricted it to such an extent that the limitation contained therein has been applied in comparatively few cases. The provision can not be applied with accuracy or with consistency." *Id.* at 13-14.

Petitioner's
Reply Brief

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No. 81-1536

In the Supreme Court of the United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS and MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. Changing their position in this litigation once again, respondents now "renounce[] any claim for the deduction of a loss on the sale of the partnership interests" (Br. 1). This concession stands in marked contrast to their claim in the Tax Court that they were entitled to a $55,739 deduction for a long-term capital loss on the sale of their partnership interests equal to the difference between their adjusted basis in their partnership interests ($1,455,739) and the fair market value ($1,400,000) of the partnership property (see J.A. 21). Although the Tax Court rejected respondents' claimed loss, the court of appeals upheld it despite respondents' reluctance to "raise that issue" on appeal (Br. 2). Respondents now, how-

ever, "acknowledge that the loss is not deductible since they did not recognize a true economic loss" (*ibid.*).

But respondents' belated generosity with the public fisc is inconsistent with the rationale of the decision below, which limits the "amount realized" by respondents to the $1.4 million value of the property at the time of disposition. At all events, their concession should not distract attention from the real issue before the Court. The direct question presented is not the allowability of respondents' claimed loss. It is whether the "amount realized" upon the disposition of respondents' partnership interests subject to their $1.85 million mortgage liability is, as we submit, $1.85 million, or the $1.4 million value of the partnership property, as respondents contend. Under the latter alternative, which respondents still support and which the decision below upheld, respondents would be entitled to the $55,739 loss, which they now voluntarily disavow. But if the amount realized includes the $1.85 million, respondents will have to recognize gain of $400,000 upon the sale of their partnership interests—the difference between the $1.85 million and their adjusted tax bases of $1.45 million. And as to that question, we submit that the teaching of this Court's decision in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), requires respondents to include the full $1.85 million in their "amount realized."

Here, respondents' partnership invested approximately $40,000 in cash in an apartment complex and financed the remainder of the project with a $1.85 million nonrecourse loan.[1] At the time respondents received the proceeds of the $1.85 million loan and invested it in the project, they properly excluded it from their gross income because of the outstanding liability to repay the loan. They also properly included the loan in their cost basis in their partnership interests on the assumption that they would pay off the debt encumbering the property. It is that assumption that supplies the rationale for including the amount of the loan in basis. If, as here, that assumption proves false because respondents disposed of their partnership interests subject to the mortgage, they are required to account for this fact by including the unrepaid mortgage indebtedness in the amount realized and recognizing the gain that proceeds from that inclusion.

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[1] Contrary to respondents' claims (Br. 11, 16-17), nonrecourse borrowing does not constitute a "co-investment" in the property by the lender. Unlike an investor, the lender on a nonrecourse note does not share in any appreciation in the value of the property, nor is he entitled to any profits or responsible for any losses attributable to the property. Although a decline in the value of the property may jeopardize the possibility that the lender will be repaid in full, that contingency does not convert the status of the lender to that of co-investor.

Indeed, respondents' position with respect to the $400,000 of gain as to which they seek to avoid recognition bears striking resemblance to the proverbial shell game in which the sought-after pea turns out not to lie under any of the shells. Respondents properly assert that the $1.85 million loan is not income at the time of receipt for they recognized a corresponding obligation to repay it. At no time during their ownership of the property (when its value declined) do they acknowledge that the $1.85 million is includable in their income. And at the disposition of their partnership interests when the final accounts must be reckoned, respondents again resist accounting for the $1.85 million despite the fact that it then became absolutely clear that they never will repay the loan. The end result, as respondents see it, is that no time is the right time to take account of their unqualified accession to the $1.85 million. Like the pea that lies under none of the shells, income inclusion has no place in respondents' accounting of the transaction.

Although respondents acknowledge that this case presents a tax "loophole" (Br. 3), they claim that the abuse in this case is the allowance of the depreciation computed on the basis of the nonrecourse debt, and that the "economic reality" (Br. 3) of "a profitless venture" should not be subject to any tax. To be sure, the tax law contains special preferences or incentives for certain activities that may be characterized as "loopholes." But the short answer to respondents' assertion is that the permanent exclusion from their income of the $1.85 million unpaid debt is not such a loophole. Indeed, the so-called loophole examples respondents cite (Br. 14-16) all involve instances in which Congress consciously determined to favor certain identified interests or activities. Here, respondents do not claim, nor can they in fact claim, that Congress expressly determined to exclude mortgage indebtedness from amount realized in the circumstances of this case. The legislative evidence, as we pointed out in our opening brief (at 48-50), is precisely to the contrary.[2]

What is more, the inclusion of the $1.85 million in the amount respondents realized on the sale of their partnership interests does not seek to "recapture" the prior depreciation deductions taken with respect to the property.

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[2] Respondents (Br. 4, 16) seek to draw support from the enactment of the at-risk rules of Section 465 and Congress' decision not to apply them to real estate investments. But as we pointed out in our opening brief (at 48-50), Congress added the at-risk rules to the Code on the explicit understanding that this Court's decision in *Crane* required inclusion of unpaid nonrecourse debt in "amount realized." Moreover, since the abuse in this case is not excessive deductions, the enactment of the at-risk rules limiting such deductions has no relevance.

Nor does Section 311(c) (26 U.S.C.), upon which respondents rely (Br. 22-23), support the view that Congress recognized that "the value of the property securing a larger nonrecourse debt is a limit on 'amount realized' " (Br. 23). Pursuant to that provision, if a corporation distributes property to its shareholders "subject to a liability, or [if] the shareholder assumes a liability of the corporation in connection with the distribution," then the corporation is taxed to the extent that such liability exceeds the corporation's adjusted basis in the property. But the fair market value limitation contained in Section 311(c) quoted by respondents applies only where the liability is *not* assumed by the shareholders, i.e., where the corporation retains responsibility for its payment. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 91 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 248 (1954). Here, on the other hand, respondents transferred their partnership interests subject to the mortgage liability securing the property.

See also Sections 357(c) and 358(d) of the Code, which provide similar rules with respect to otherwise tax-free transfers of prop-

We have never disputed the propriety of respondents' depreciation deductions taken with respect to the property. By ascribing significance to the value of the property at the time of disposition, the abuse permitted by the court of appeals in this case is not excessive depreciation deductions but the allowance of a tax loss where no economic loss has occurred.[3]

The correctness of this proposition is easily demonstrated if we assume that respondents' partnership purchased a nondepreciable asset such as land. To pose the

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erty to controlled corporations pursuant to Sections 351 or 361. Under these provisions, if a taxpayer transfers property to a controlled corporation subject to a liability in excess of his basis, he realizes taxable gain to the extent the liability exceeds his basis in the property. 26 U.S.C. 357(c)(1). The liability transferred with the property is treated in these circumstances "as money received by the taxpayer on the exchange." 26 U.S.C. (Supp. IV) 358(d)(1).

[3] Thus, the measure of the gain we contend respondents realized here does not equal the deductions their partnership took with respect to the apartment complex. Rather, that gain is measured by the difference between their adjusted tax basis in the partnership and the unpaid amount of the nonrecourse debt of which the partnership was relieved upon sale. Only where, as here, the partnership was nearly 100% financed by nonrecourse debt and the debt was never reduced by payments on the principal does the gain on disposition subject to the debt roughly approximate the deductions taken.

Respondents also err (Br. 7) in characterizing *Crane* as turning on the tax benefits enjoyed by Mrs. Crane during her ownership of the property. There, this Court upheld the Commissioner's computation charging the taxpayer with $23,500 of gain, despite the fact that the deductions she claimed during the seven-year period of her ownership resulted in a tax saving of only $150 to $200. See Petitioner's Reply Brief at 4, *Crane* v. *Commissioner*, No. 68 (1946 Term).

Nor are respondents correct in their claim (Br. 25) that there is no "amount realized" "[i]n the absence of enhanced financial or economic condition either through the acquisition of valuable assets or the reduction of true debt." In *Crane*, the only material item received by the taxpayer upon her sale of the building was $2,500 in cash. But this Court required the inclusion of the $262,000 nonrecourse mortgage in "amount realized," where the mortgage had likewise been included in her cost basis.

case in its starkest terms, suppose respondents had put up no cash and had obtained a $1.85 million nonrecourse note. If the value of the land declined to $1.4 million and respondents then sold the property subject to the mortgage, the decision below would have awarded them a $450,000 capital loss, computed by subtracting their $1.85 million basis from the $1.4 million amount realized.

But in such a case, respondents surely are not entitled to any loss. They have not disbursed a single dollar, and are not in any sense poorer than they were before the transaction. Rather, as we submit, the amount realized in such a case is $1.85 million. Since the amount realized is precisely equal to their $1.85 million basis, respondents will report neither gain nor loss as a result of the sale. In these circumstances, their tax reporting conforms to the economic reality of the situation. Indeed, once respondents determined to part with the property, the value of the property ceased to have any relevance to them. As one distinguished commentator has observed, "Whether the value of the property at that time is just barely sufficient to pay off the debt, or falls short of that amount, and what happens to its value thereafter, are matters of concern to the mortgagee and the new owner; but the old owner has no reason to worry about these matters." Bittker, *Tax Shelter, Nonrecourse Debt and the Crane Case*, 33 Tax L. Rev. 277, 284 (1978). It is therefore the lender on the nonrecourse note, and not respondents, who may bear the economic and tax loss attributable to any decline in the value of the property in these circumstances. Thus, the "economic reality" invoked by respondents convincingly refutes their claim to exclude the $1.85 million from amount realized. See also our opening brief (at 23).

2. Contrary to respondents' further argument (Br. 24), there is no necessary correlation between the amount realized by them and the purchaser's basis in the property. As a general matter, the amount that the seller realizes on a sale will usually correspond to the purchaser's cost basis in the property, especially where cash

alone is paid for the property. But where, as here, the property declines in value and is sold subject to nonrecourse indebtedness exceeding the fair market value of the property, the seller's benefit does not correspond to the detriment incurred by the buyer in taking the property subject to the debt. Here, respondents received cash of $1.85 million when they purchased the property. Once it became clear that they would never repay that amount, it was appropriate to include it in their "amount realized." When the buyer, Bayles, took over the property subject to the mortgage, when the value of the property had declined to $1.4 million, he did not receive the cash equivalent of $1.85 million. Rather, he received only property then worth $1.4 million. Hence, his basis and the amount realized upon his sale of the property will include, at most, only $1.4 million of the debt. See Treasury Regulations on Income Tax (1954 Code), Section 1.1001-2(a)(3) (26 C.F.R.).

3. Finally, we reject the amicus Barnett's thesis—apparently shared by respondents to some degree (see Resp. Br. 12-13)—that the gain in this case is ordinary income from the cancellation of indebtedness under Section 61(a)(12).[4] Under Barnett's view, the transaction at issue should be recast as two separate events: (1) the transfer of the property for $1.4 million; and

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[4] Respondents advance the Barnett theory apparently on the belief that they would be able to defer the gain under Sections 108 and 1017 of the Code. But the record does not reflect that respondents made the necessary election under Section 108(c) and (d), or that they have any depreciable property available upon which to apply the complementary basis reduction rules of Section 1017. At all events, even if Sections 108 and 1017 were deemed applicable, respondents' bases in their partnership interests would be reduced by the amount excluded under Section 108, viz., $450,000. See Section 1017(b)(3)(C). When they sold their partnership interests for the $1.4 million value of the property, they would still be deemed to have received capital gain equal to $400,000 upon the disposition of their partnership interests ($1.4 million minus $1 million basis in their partnership interests). See our opening brief (at 47-48 n.36).

(2) the discharge of the $1.85 million liability for $1.4 million. Under his analysis, the first component of the transaction produces the capital loss of $50,000 that respondents have now renounced. He further concludes that the second component of the transaction produces $450,000 of ordinary income, rather than the capital gain determined by the Commissioner. Thus, [illegible] the amicus sees the matter (Br. 2), the real issue in the case is not encompassed in the question presented in the petition. Instead, the question he seeks to put before the Court "is not *how much* gain the taxpayers realized but only *what kind* of gain it was" (emphasis in original).

If one were writing on a clean slate in this area and considering the question as an original matter, one might construct a theory that would assign "basis" to liabilities, attribute significance to the value of nonrecourse liability securing property at the time of its cancellation, and break down a disposition of property subject to a nonrecourse mortgage into its component parts. In these circumstances, one could well conclude that ordinary income treatment for respondents' relief from indebtedness would be appropriate. Indeed, if respondents are correct in urging that their amount realized is limited to the $1.4 million value of the property, then the gain that respondents unquestionably realized must be accounted for as ordinary income from the cancellation of indebtedness.

But the tax law has not traveled down that path and no one in this litigation or in any of the previous cases has urged that the gain realized in such circumstances is taxable as ordinary income. Indeed, apart from the anomaly of the decision below, the entire history of the tax treatment of mortgage indebtedness at least since *Crane* evidences a consistent judicial treatment requiring the inclusion of the full amount of the nonrecourse mortgage debt in the amount realized for the property, regardless of the value of the property upon disposition.[5]

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[5] Of course, if property is transferred in exchange for the discharge of an unrelated recourse debt, the transaction may produce ordinary income from the discharge of indebtedness under Section

See our opening brief (at 35-45); *Lutz & Schramm Co.* v. *Commissioner*, 1 T.C. 682, 689 (1943); *R. O'Dell & Sons Co.* v. *Commissioner*, 8 T.C. 1165 (1947), aff'd, 169 F.2d 247 (3d Cir. 1948). See also S. Surrey, W. Warren, P. McDaniel & H. Ault, *Federal Income Taxation* 857 (1972); *Danenberg* v. *Commissioner*, 73 T.C. 370, 381 (1979). Given this well-established line of authority, it is simply too late in the day to expand the scope of the question presented in this case so as to recast these transactions involving mortgage debt and recharacterize the nature of the gain. The Commissioner's longstanding position to permit such gain to be attributed to the transfer of the property subject to the mortgage debt is a reasonable and permissible interpretation of the statutory definition of "amount realized" in Section 1001(b). *United States* v. *Correll*, 389 U.S. 299, 307 (1967).

Requiring an unraveling of the various components of assets and obligations conveyed in the sale of property subject to a mortgage, and an individualized computation and characterization of the income or loss realized upon each of these components, would introduce complexities of enormous dimensions into the taxation of any sale of property subject to a purchase money obligation. See *Helvering* v. *Midland Insurance Co.*, 300 U.S. 216, 225 (1937). Moreover, it would run directly counter to the general rule that requires the various intangible elements of the value of real property to be treated as inseparable parts of the fee. See *Hort* v. *Commissioner*, 313 U.S. 28 (1941); *Millinery Corp.* v. *Commissioner*, 350 U.S. 456 (1956); *Schubert* v. *Commissioner*, 286 F.2d 573 (4th Cir.), cert. denied, 366 U.S. 960 (1961). Ignoring, as it does, the fundamental fact that taxation is an intensely practical affair (e.g., *Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941)), the amicus' argument is that Congress has inadvertently added "a colonial wing to a gothic cathedral."

61(a)(12) of the Code. See Treasury Regulations on Income Tax (1954 Code), Sections 1.1001-2(a)(3) and 1.1001-2(c), Example (8). See also *United States* v. *Davis*, 370 U.S. 65, 72 (1962).

ICC v. *J-T Transport Co.*, 368 U.S. 81, 115 (1961) (Frankfurter, J., dissenting).

The fundamental thesis of the amicus' brief, however, is in accord with our submission that respondents here realized $400,000 in gain when they sold their partnership interests and transferred the partnership property subject to the outstanding debt. While we cannot agree with the amicus' characterization of that realization as ordinary income, the decision below that there was no such realization at all cannot stand. Absent a conscious decision by Congress to recharacterize such a realization as ordinary income, the Commissioner's determination to tax the amount as capital gain should be upheld.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

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Amicus Brief

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OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN F. TUFTS and MARY A. TUFTS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF FOR *AMICUS CURIAE*

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

Pursuant to Rule 36.3, the undersigned, a member of the Bar of this Court who is appearing *pro se,* moves for leave to file the attached brief as an *amicus curiae*. Consent to the filing of the brief has been granted by the respondent but has been withheld, for reasons of policy, by the Solicitor General.*

The *amicus* is a teacher and scholar of the tax law. The issues in this case involve a subject in which he has a special interest and about which he has been engaged for some time in writing. Except for that academic interest, he has no interest in the outcome of this case.

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* The *amicus* was orally advised by the Assistant to the Solicitor General principally responsible for the case that the Office would welcome the filing of the attached brief but as a matter of policy declined to consent to the filing of *amicus* briefs by individuals (as opposed to organizations) with no financial stake in the outcome of the case.

As can be seen from the "Summary of Argument" in the attached brief, the *amicus* takes a view of the issues involved in this case and their proper resolution that is wholly different from that taken by either of the parties. The issues are important, and in resolving them the Court should have the benefit of a presentation of all the competing views.

CONCLUSION

For the reasons stated, the motion for leave to file the attached brief should be granted.

Respectfully submitted.

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OCTOBER 1982

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JOHN F. TUFTS and MARY A. TUFTS, ET AL.

BRIEF FOR *AMICUS CURIAE*

SUMMARY OF ARGUMENT AND INTRODUCTION

In 1970, the taxpayers borrowed $1.85 million on a nonrecourse note secured by an asset they owned. In 1972, having in the meantime repaid none of the amount borrowed, they transferred the asset, subject to the mortgage, to a third party. At the time of its transfer to the third party, the asset was worth only $1.4 million. The question is how the 1972 transaction should be accounted for.

As it has been framed by the government, the question has to do exclusively with the computation, under § 1001(a) of the Code, of the taxpayers' gain or loss from their disposition of their asset and, more particularly, with the determination under § 1001(b) of the "amount realized" by them from their disposition of the asset. The "amount realized," the government contends, must be set equal not to the value of the asset when it was disposed of ($1.4 million) but to the amount of the unrepaid loan proceeds that the taxpayers had earlier obtained by mortgaging the asset ($1.85 million). The prior loan proceeds must be included in the "amount realized," according to the government, because otherwise the taxpayers "will escape taxation forever" on the part of the receipts not so included (Pet. Br. 19).

In so framing the issue, the government presents a false dilemma. The prior loan proceeds must indeed be accounted for, but the proper way to account for them is to treat them not as an amount received for the *asset* but as what they are: an amount received for the note the taxpayers issued and hence for the *liability* they thereby accepted. A taxpayer who buys in a note for less than he received for issuing it (his "basis" for the liability) has a gain equal to the difference – what the statute calls "income from the discharge of indebtedness" (§§ 61(a)(12) and 108) but what will here be called simply a "liability gain". And it is specifically in the computation of *such* gains, not of asset gains, that one properly accounts for receipts for accepting liabilities.

It is evident too that, since the asset was all they gave up for it, the taxpayers cannot be deemed to have *expended* for their relief from the liability any more than they are deemed to have *received* for the asset. If, then, as the court below held they should be, they are deemed to have received for their asset only an amount equal to its value – $1.4 million – then $1.4 million is also the only amount they can be deemed to have paid to be relieved of the liability. And since their basis for the liability was $1.85 million, that would mean they realized a *liability gain* of $450,000. The result, it may be seen, is that the *total* gain the taxpayers realized (their asset gain or loss plus their liability gain or loss) will be the same *however* the amount of the deemed receipt (for the asset) and expenditure (for the liability relief) is fixed. What turns on the issue mooted by the parties, then, is not *how much* gain the taxpayers realized but only *what kind* of gain it was.

It is equally clear, finally, that the amount that the taxpayers should be deemed to have received and expended should indeed be measured, as held below, by the *values* of the exchanged items. That is the measure universally used in accounting for in-kind transactions; the measure required to be used if economically equivalent transactions are to be treated alike; the measure the Code (§ 1001(b)) expressly prescribes; and the measure adopted by this Court's decision in *Crane*.

It follows that on the one question the government addressed in the courts below and poses as the "Question Presented" here, the decision below is correct and the government wrong. Whether in the particular posture of this case, that means that the judgment below should simply be affirmed – or whether instead the Court should now sustain the tax deficiency on the basis on which it *should* have been asserted (*i.e.*, the realization of a liability gain) – is a question that, being of concern only to the parties, is not addressed in this brief.

ARGUMENT

The transaction at issue is an "in-kind" transaction in which an asset is exchanged for relief from a liability. To deal with such a transaction, though, one needs first to know, among other things, the rules that apply to dealings in liabilities when the amounts received and paid are in money rather than in kind. Those rules are examined in Point I; the issues posed by in-kind transactions as such, in Point II.

I. THE TAX TREATMENT OF DEALINGS IN LIABILITIES

A. THE AMOUNT RECEIVED FOR ACCEPTING A LIABILTY IS EXCLUDED FROM INCOME AND FIXES THE TAXPAYER'S ORIGINAL "BASIS" FOR THE LIABILITY.

That borrowed moneys need not be included in income is a settled and familiar rule. Familiar too is its justification: the acquired liability imposes a burden on the taxpayer presumably of a value equal to the amount of money received and he therefore has as yet had no gain. The treatment, it may be seen, is analogous to that of a purchase of an asset. An amount paid to acquire an asset is similarly not immediately deductible (§ 263) and the reason is fundamentally the same: the acquired asset presumably has a value equal to the amount expended and the taxpayer therefore has as yet had no loss.

A rational system for measuring income also requires, however, that all receipts and expenditures be accounted for *at some time* and hence that those that are not finally accounted for when they occur be kept in a suspense account so that proper account can be taken of them at another time. In the case of an asset, the amount that needs to be kept track of (the unaccounted-for prior expenditures) has by statute been given a name – it is the taxpayer's "basis" for the asset (§ 1012) – and the necessity of having such an account is therefore familiar. But there is obviously just as much need to keep track of a taxpayer's unaccounted for prior receipts with respect to a liability, and that amount too needs to have a name.

Recognizing that the needed account serves exactly the same function with respect to a liability that the "basis" account serves with respect to an asset, Professor Andrews has suggested that it can similarly be referred to simply as the taxpayer's "basis" for the liability.[1] That is a convenient and entirely appropriate usage, and it is the usage that will be adopted here.

Inasmuch as a taxpayer's basis for a liability is by definition the amount of his prior receipts that haven't *yet* been accounted for, the basis must obviously be adjusted downward whenever any part of the receipts reflected in the basis have been otherwise accounted for – *e.g.*, by inclusion in income or by nonallowance of a deduction for an expenditure treated as a repayment of the amount received. Just as is true with respect to assets, however, the nature and amount of the adjustments needed for that purpose will usually be obvious, and the point need not be belabored.

B. A PURCHASE OF RELIEF FROM A LIABILITY CAUSES THE REALIZATION OF A GAIN (OR LOSS) EQUAL TO THE DIFFERENCE BETWEEN THE BASIS OF THE LIABILITY AND THE AMOUNT EXPENDED FOR THE RELIEF.

It was held in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), that if a corporation repurchases for $95 a bond that has a par value of and was issued for $100, it will realize a taxable gain of $5. That much is clear. By noting that the par value of the bond and the amount received on its issuance were the same, however, the opinion in *Kirby Lumber* left unresolved a crucial issue: in computing the gain from such a transaction, is it ultimately (1) the *par value* of the bond or (2) the *amount received* by the taxpayer for its issuance (his "basis" for the liability) that is relevant?

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[1] Andrews, Federal Income Taxation of Corporate Transactions 183 (1979).

Fortunately, the ambiguity is easy enough to resolve: we need only look to see how the gains are in fact measured, under the prevailing rules, when a corporation repurchases a bond that was issued at a price *different* from its "par value" (or stated "principal" or "face" amount). Consider, for example, these two cases:

> (1) Corporation *X* issues for $108 a bond with a par value of $100. A week later, following a rise in interest rates, it buys in the bond for $102.
>
> (2) Corporation *Y* issues for $90 a bond with a par value of $100. A week later, following a drop in interest rates, it buys in the bond for $93.

What gain or loss would each of those corporations be held to have realized? The answer given by the regulations – and universally accepted as the only possible answer – is precisely what one would expect: *X*, having initially received $6 more than it later paid out, had a gain of $6, while *Y*, having paid out $3 more than it initially received, had a loss of $3.[2] The fact that *X*'s bond had a stated par value that was less than the amount it paid out (suggesting a loss) and *Y*'s, a par value that was greater (suggesting a gain), is simply irrelevant. It is not numbers recited in documents that produce gains and losses, but *receipts* and *expenditures*, and it is therefore only the obligor's prior receipt for accepting the liability – his basis for the liability – that is in fact of any relevance.

With that clarification of the content of the rule – and with the simplification of its language made possible by the recognition of a "basis" account for liabilities as well as for assets – the rule governing the computation of liability gains and losses becomes as simple, and as readily comprehensible, as that governing the computation of gains and losses from sales of assets (see § 1001(a)). The rule, put in more or less formal terms, is as follows:

> The gain or loss realized by a purchase of relief from a liability is equal to the difference between the adjusted basis of the liability and the amount expended for the relief.

---

[2] See Regs., §§ 1.61–12(c)(3) (gains) and 1.163–3(c) (losses).

C. GAINS DERIVED FROM DEALINGS IN ASSETS ("ASSET GAINS") AND GAINS DERIVED FROM DEALINGS IN LIABILITIES ("LIABILITY GAINS") HAVE DIFFERENT CHARACTERS FOR TAX PURPOSES AND MUST BE SEPARATELY ACCOUNTED FOR.

Gains derived from dealings in liabilities, referred to in the statute as "income from the discharge of indebtedness" (§ 61(a)(12)), do not qualify as capital gains and are taxable in full as ordinary income. They are different from gains derived from dealings in assets also in another important respect: if the taxpayer is a corporation or the indebtedness was incurred in connection with business property, the taxpayer may elect under §§ 108 and 1017 to exclude the gain from his current income and account for it instead by making a corresponding reduction in his basis for certain assets, thereby effectively deferring the ultimate inclusion of the gain. Losses from the two sources, finally, are also treated differently: losses from sales of assets are often allowable only as capital losses, while losses from liability transactions are always deductible in full as ordinary losses (Regs., § 1.163-3(c)).

The different tax treatment of gains and losses derived from dealings in liabilities and those derived from dealings in assets makes it important that the distinction between them be maintained. Shorthand names for the two kinds of gains will facilitate the making of that distinction, and to that end they will be referred to here as simply "liability gains" and "asset gains," respectively (and similarly, of course, for losses).

D. NONRECOURSE LIABILITIES ARE TREATED FOR TAX PURPOSES AS THE LIABILITIES OF THE OWNER OF THE PLEDGED ASSET AND ARE ACCOUNTED FOR AS ARE OTHER LIABILITIES.

The case at bar involves a *nonrecourse* liability, and we need also to consider, therefore, to what extent nonrecourse liabilities are treated as are other liabilities.

The fundamental issue of classification is that posed by a simple nonrecourse borrowing like the following: *A*, owning an asset with a basis of $100, pledges the asset as security for a $60 nonrecourse loan. The question is how *A*'s $60 receipt should be accounted for.

It might have been plausible as an original matter, as some have suggested, to treat such a transaction not as a "borrowing" but as a "disposition" of a senior interest in the asset and a retention only of an "equity," and thus to account for *A*'s $60 receipt simply by reducing his basis for the asset (for depreciation purposes, among others) from $100 to $40.[3] Whether a coherent set of rules so premised could be worked out is unclear, but the question is in any case academic since that is obviously not the course we have taken.

The course we have taken, rather – from the very beginning of the income tax and not, as sometimes seems to be suggested, as a result merely of the *Crane* decision[4] – is to treat the owner of a pledged asset as the "obligor" of a "liability" and thus to treat *A*'s transaction as indeed but a simple "borrowing." In recognition of his acceptance of an offsetting liability, that is to say, we exclude his $60 receipt from his income and account for it, as we account for all borrowed money, simply by assigning to his liability a "basis" (later in some way to be accounted for) of $60. We treat the transaction, in short, not as an "asset" transaction to be accounted for by an adjustment to *A*'s "asset" accounts, but as the opening of an entirely distinct "liability" transaction that is to be separately and independently accounted for.

It is equally on that premise, of course, that we account for the mortgagor's subsequent dealings with respect to the liability. Installment payments he makes to the mortgagee are characterized simply as payments of "interest" and "principal" on a "debt" and are accounted for just as such payments on debts usually are. A later buying-up of the mortgage is similarly treated just as are repurchases of notes by a maker who is personally liable: the difference between the amount paid and the mortgagor's basis is treated simply as a gain or loss from the repurchase of a debt (for purposes, *e.g.*, of § 108). And that, of course, is just as it should and must be: given the treatment of the "opening" transaction as an independent liability-creating transaction, no other treatment of the "closing" transaction would be coherent.

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[3] In a case in which the note proceeds exceeded the asset's basis, the excess would (under that approach) presumably be included in income as a gain from the disposition of the interest deemed disposed of. That, indeed, is precisely the claim that was made (and rejected) in *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).

[4] *Crane v. Commissioner*, 331 U.S. 1 (1947). *Crane*, of course, even if not its source, is indeed the controlling judicial authority for the doctrine.

It is asserted, in sum, that the basic principle governing the treatment of nonrecourse liabilities is the following:

> The owner of an asset pledged as the security for a nonrecourse debt is to be treated for tax purposes not as the owner merely of an "equity" but as both (1) the owner in full of the asset and (2) the obligor of the debt, and thus as having entered into two separate and distinct transactions that must be independently accounted for.

It is asserted also that it is more fundamentally for that proposition than for any other that the *Crane* case truly stands.

E. SUMMARY

For reasons that will become clear in the next part (where a variation of the same case is used), the conclusions reached in this part can be most usefully summarized by applying them to the facts of the following hypothetical case ("*G*'s case"):

> In year 0, *G* pays $185 for a farm, a nondepreciable asset.
>
> At the beginning of year 1, at a time when the prevailing interest rate for like mortgages is 5%, *G* receives $115 from *M*, an investor in mortgages, in exchange for a nonrecourse note secured by a mortgage on the farm. The note calls for 30 annual "interest" payments of $6 each (on December 31 of each year) and a single "principal" payment, at the end of 30 years, of $100.[5]
>
> During years 1–10, *G* makes payments on the note, as required, totalling $60. In conformity with the treatment

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[5] Discounted at 5%, the "present value" of such a stream of payments is approximately $115, and it is that that accounts for M's willingness to pay that amount for the note. My reason for stipulating a discrepancy between the amount for which the note was issued ($115) and its stated "principal" amount ($100) is simply to force recognition that the two amounts are not *necessarily* the same (though they often are) and hence that it is necessary to distinguish between them. My reason for stipulating an "interest-only, balloon-payment" note is just to simplify the accounting for the annual payments.

prescribed by the regulations for corporate bonds issued at a "premium" (§ 1.61–12(c)(2)). *G* claims "interest" deductions for only $55 of the amounts so paid ($5.50 a year) and treats the remaining $5 of the payments ($0.50 a year) as a nondeductible repayment of the amount he received on the issuance of the note.

At the beginning of year 11, at a time when the prevailing interest rate for like mortgages is 8%, *G* pays $80 to *M* in exchange for a surrender of the note and mortgage.[6] A week later, *G* sells the farm to a third party, *P*, for $200.

Under the rules discussed in this part, those events would have the following tax consequences:

Year 0: G's expenditure of $185 in exchange for the farm would not be deductible (§ 263) and would be accounted for by crediting *G* with a basis of $185 for the asset thus acquired (§ 1012).

Year 1: G's receipt of $115 in exchange for the note and mortgage would not be included in his income and would be accounted for by charging *G* with a basis of $115 for the "liability" thus accepted.

Years 1–10: G would be allowed the claimed "interest" deductions for $55 of the payments made on the mortgage. The remaining $5 of the payments would be accounted for by a reduction of *G*'s basis for the liability. *G*'s adjusted basis for the liability at the end of year 10 would accordingly be $110.

Year 11 (mortgage repurchase): On his repurchase of the mortgage, *G* would be deemed to have realized a gain of $30, the excess of his basis for the mortgage ($110) over the amount expended for the relief ($80). The gain would be characterized as a liability gain and would accordingly (1) qualify for elective deferral under § 108 but (2) otherwise be taxable as ordinary income.

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[6] *G*'s remaining liability at that time was to pay $6 a year for 20 years and then to pay $100. Discounted at 8%, the "present value" of such a stream of payments is approximately $80, and it is that that accounts for the mortgage's then being worth only $80.

Year 11 (farm sale): On his sale of the farm, *G* would be deemed to have realized a gain of $15, the excess of the amount realized ($200) over his basis for the farm ($185). The gain would be characterized as an asset gain and would accordingly (1) not qualify for deferral under § 108 but (2) be taxable (in the usual case) as a capital gain.

It is not believed that either the government or the respondent would disagree with any of those conclusions.

II. AN IN-KIND EXCHANGE OF AN ASSET FOR RELIEF FROM A LIABILITY CAUSES THE REALIZATION OF (1) A LIABILITY GAIN EQUAL TO THE EXCESS OF THE TAXPAYER'S BASIS FOR THE LIABILITY OVER THE VALUE OF THE ASSET AND (2) AN ASSET GAIN EQUAL TO THE EXCESS OF THE VALUE OF THE ASSET OVER THE TAXPAYER'S BASIS FOR THE ASSET.

To present the fundamental question that is at issue in this case – in what is at once both its simplest and its most general form[7] – it is necessary to make only one modification in the facts of *G*'s case as just given. The required modification is a substitution of the following for the events of year 11:

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[7] In the case put here, as will be seen: (1) no depreciation deductions whatever have been taken by the taxpayer; (2) the asset was acquired and its basis fixed entirely independently of the borrowing transaction and the borrowed funds were used instead for a wholly different (and undisclosed!) purpose; and (3) the asset transferred has a value much in excess of the basis and value of the liability. Yet the case put will be found to present exactly the same question as does the actual case, thus making clear that – notwithstanding the stressing of such features by the government and the lower courts – the fundamental issue has nothing as such to do with "double deductions"; with "artificially inflated" bases for assets; with a liability's having been "included" in an asset's basis; with there existing any relationship at all ("functional" or otherwise) between the "basis" of an asset and the "amount realized" on its disposition; or with the asset's having a value less than the basis of the liability. Needless to say, it was precisely with the goal of eliminating such nonessential and distracting features, and thereby more clearly isolating the fundamental issue, that the facts of the case put here were chosen. And it is for that reason too, of course, that the discussion here focuses on the hypothetical case rather than the actual one.

In point of fact, it's also not crucial even that the basis of the liability be *greater* than its value (the case put here): as will be seen later (pp. 26–28, *infra*), the problem arises equally when the liability's basis is *less* than its value. In truth, the only case in which the problem is *not* present is the special case in which the liability's basis and its value happen to be exactly equal.

> At the beginning of year 11, *G* conveys the farm to *P*, subject to the mortgage, in exchange for $120. At the date of that transaction, the mortgage has a market value of $80 [as before] and the farm has a market value of $200 [as before].

The difference between the two versions of the case, it will be seen, is that in the first version (the "for-money" version) the relief from the liability is procured, and the farm disposed of, in separate "for-money" transactions.[8] In the second version (the "in-kind" version), the two transactions are instead combined (in part) into an "in-kind" transaction in which what is given for the relief from the liability is an interest in the farm and what is received for the interest in the farm is the relief from the liability. And it is precisely that difference, of course, that poses the issue to be decided: to wit, how the *in-kind* component of such a transaction should be accounted for.

The government would argue that *G* should be treated as having received for the farm, in addition to the $120 he received in cash, an amount equal to his *basis* for the liability, $110. That would give him a total "amount realized" of $230 and hence a gain of $45 ($230 less his basis for the farm, $185). The entire $45 gain would be treated as a gain from the sale of the farm and hence as a capital gain.

Under the court of appeals decision, in contrast, *G* would be deemed to have received for the farm, in addition to the $120 in cash, an amount equal only to the *value* of his relief from the mortgage liability, $80. That would give him a total "amount realized" of only $200 and hence a gain from his disposition of the farm of only $15. What *liability gain G* might also have had is an issue that was neither raised nor addressed.

The view urged here agrees with the court of appeals that *G* should be deemed to have received only $80 by virtue of his relief from the liability and hence to have had an *asset gain* of only $15.

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[8] *I.e.*, transactions in which the receipts and expenditures of which account needs to be taken are themselves in the form of money. The phrase is neither elegant nor commonly used, but it fills the need for a term to be used in contradistinction to "in-kind" transactions.

Unlike the court of appeals, however, it goes on to recognize the necessary corollary: to wit, that *G* must likewise be deemed to have ***expended*** only **$80** to procure his relief and must therefore be deemed to have realized also a **$30** ***liability gain*** (the excess of his **$110** basis for the liability over the amount so expended).

A. THE AMOUNT DEEMED EXPENDED FOR THE LIABILITY RELIEF AND THAT DEEMED RECEIVED FOR THE ASSET MUST BE EQUAL.

Income is reckoned in money, and it is accordingly only by "imputing" to the parties receipts and expenditures of money that we can account for an in-kind transaction. We do that, in effect, by recasting the actual transaction into an economically equivalent set of for-money transactions and treating the parties just "as if" that is what had occurred. We thus treat:

> – one who exchanges a horse for a cow as if he had (1) received **$X** for the horse and (2) paid **$X** for the cow;[9]
>
> – one who receives a share of stock as a bonus, as if he had (1) received **$X** as a bonus and (2) paid **$X** for the stock;
>
> – one who gives an employee a share of stock as a bonus, as if he had (1) paid **$X** to the employee and (2) received **$X** for the stock;[10]
>
> – one who issues a note in exchange for an asset, as if he had (1) received **$X** for the note and (2) paid **$X** for the asset; etc., etc.

It will be observed that in accounting for such transactions there are always both a ***receipt*** and an ***expenditure*** to be accounted for and that the two items are always ***equal*** in amount (the same **$X**). It is also easy to see why that must be: the taxpayer did not in fact receive or expend any money at all, and to treat him as having had a ***net*** receipt or expenditure of money is therefore inconsistent with the actual transaction. Simply from the requirement that the "deemed" transaction and the actual one produce the same end result, then, we can arrive at the following conclusion: whenever there is attributed to a taxpayer a receipt or expenditure of money that has not in fact occurred, there must also be attributed to him an equal and offsetting expenditure or receipt. That is what might be called the "reciprocity constraint" on the imputation of money payments, and if there are any imperatives in the tax law, that is surely one of them.

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[9] *Philadelphia Park Amusement Co. v. U.S.*, 126 F. Supp. 184 (Ct. Cls. 1954).

[10] *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943); *U.S. v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960).

Although in *G*'s case there is also an actual receipt of money that can be directly accounted for, a major part of the transaction is an in-kind transaction and that part, like other in-kind transactions, can be accounted for only by recasting it as a series of for-money transactions. What is required, more specifically, is that *G* be treated just as if he had:

(1) sold the farm for $(120 + X); and
(2) paid $X for relief from the mortgage liability.

The critical points, as will be seen, are (1) that there are two distinct transactions to be accounted for, a sale of an asset ***and*** a purchase of relief from a liability, and (2) that *G* must be deemed to have ***expended*** for his relief from the liability the same amount, whatever it is (*i.e.*, the same $X), that he is deemed to have ***received*** for the farm by virtue of his receipt of that relief. Neither of those critical points, in turn, can reasonably be doubted.

G's transaction with *P* brought to an end not only his ownership of the farm but also his deemed "obligorship" of the mortgage liability, and a termination of a liability is no less a realizing event than is a disposition of an asset. It is an event, to be precise, that causes the realization of a gain equal to the excess of (1) the taxpayer's "basis" for the liability over (2) the "amount expended" by him to obtain the relief. *G*'s basis for the liability, we know, was $110, and all that remains to be determined, to compute his liability gain, is his "amount expended" for the relief.[11]

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[11] Note the implication: for a taxpayer to assert that he neither received nor expended anything when he disposed of his mortgaged property (say, by surrendering it to the mortgagee) is in effect for him to assert not that he had ***no gain*** but that he had a very large ***liability gain*** – to be precise, one equal to his full basis for the liability! A taxpayer who would prefer an asset gain to a liability gain (*e.g.*, because an asset gain would be a capital gain) would thus do well to find another claim to make!

That *G* must be deemed to have expended for his relief from the liability the same amount he is deemed to have received for the asset exchanged for the relief, in turn, is but a straightforward application of the same principle that tells us, with universal acceptance, that a taxpayer who exchanges a horse for a cow must be deemed to have paid for the cow the same amount that he is deemed to have received for the horse.[12] And here too, as always, the recognition of equal and offsetting imputed payments is essential to make the accounting conform to the actual results of the transaction: except for the $120 receipt that is being separately accounted for, *G* neither received nor expended any money at all, and he cannot rationally be treated (in the net) as if he had.

Innocent and obvious though those propositions be, they reveal the issues and stakes in this case to be wholly different from what the parties suppose them to be. What they mean is that, contrary to the parties' assumptions, the resolution of the "amount realized" question the government presents will in fact have no effect whatever on the *total* amount of the gain that *G* must be held to have realized. All that it will determine, to the contrary, is the *character* of the gain: how much is to be treated as an asset gain (and hence as a capital gain) and how much as a liability gain (and hence as ordinary income potentially deferrable under § 108).

That can be seen most easily simply by examining what the results would be if, in conformity with the decision below, *G* were treated as having received for the farm, by virtue of his relief from the mortgage, only an amount equal to $80 (the value of the mortgage). The direct effect, of course, would be to cause *G*'s realized *asset gain* to be limited to $15 ($120 + $80 – $185). If, however, *G* is deemed to have *received* only $80 by being relieved of the liability, he must likewise be deemed to have *expended* only $80 to procure the relief. *G*'s basis for the liability, we know, was $110, and his purchase of relief from the liability for only $80 would thus give him a *liability gain* of $30. And that, added to his asset gain of $15, would give him a *total* realized gain of $45, exactly what the government says it should be!

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[12] *Philadelphia Park Amusement Co. v. U.S.*, note 9, *supra*.

What turns on the "amount realized" question debated by the parties, in short, is not *whether* *G*'s entire economic gain ($45) is to be taxed – the issue as the government frames it – but only *how* it is to be taxed: whether (1) the entire $45 gain is to be treated as an asset gain or (2) only $15 of the gain is to be so treated and the remaining $30 accounted for instead as a liability gain.[13]

B. THE AMOUNT DEEMED EXPENDED FOR THE LIABILITY RELIEF AND RECEIVED FOR THE ASSET SHOULD BE DETERMINED BY THE VALUES OF THE EXCHANGED ITEMS.

The question that remains is how the specific amount of the receipt and expenditure that are to be imputed is to be determined. I argue that that it should be measured by the *values* of the exchanged items[14]; the government, by the taxpayer's *basis* for the liability. The affirmative case for using value as the measure is presented in this section. The opposing rule advanced by the government is examined (and criticized) in the next section.

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[13] An escape of the entire gain from tax was, to be sure, the consequence that obtained in the actual case as it was disposed of by the court below, but that was the result only of the government's self-fulfilling prophecy: that's what the government itself *told* the court would necessarily follow if the court adopted (as it did) a "value" measure of the amount realized.

[14] The reference in the plural to the values of the items exchanged is deliberate, inasmuch as there is no reason per se to regard the value of either item as being of more significance than that of the other. There is, to be sure, a common assumption, reflected in the statute (*e.g.*, in § 1001(b)), that receipts are to be measured by the value of what is *received*. But so too is it commonly supposed, again with support in the statute (e.g., § 1012), that *expenditures* are to be measured by the value of what is *given*. And the problem is that, in an *in-kind* transaction, there are always both a receipt *and* an expenditure to be accounted for, with its being imperative above all else that they be fixed in the *same* amount! Plainly then, neither of the two presumptive measures has more standing than the other, and the problem is best seen as one simply of devining from all the evidence at what price in money the two transactions would most likely have been concluded had they been effected separately. The problem, though, is more academic than real: the exchanged items are almost invariably found to be equal in value (if only by the use of a convenient presumption!) and when that is the case (as it is here) the problem disappears.

1. *Consistency with basic principles and the treatment generally of in-kind transactions.* - *G*'s in-kind transaction was identical in its economic effects (for *G* at least[15]) to the for-money version first examined. Economically equivalent transactions should receive like treatment. Ergo, *G*'s in-kind transaction should have the same tax consequences as the for-money version: which is to say that *G* should be treated just "as if" he had bought his relief and sold his farm for amounts equal to the prices that would presumably be paid in separate for-money transactions (*i.e.*, their *values*).

The force of that simple syllogism lies not alone in its intrinsic appeal but as well in its universality: it is essentially that same syllogism and its premise that underlies the whole of the body of law, statutory and otherwise, that governs the treatment of in-kind transactions. It is just such a syllogism that tells us that an employee who receives as compensation a share of stock worth $100 should be required to include $100 in his income and be allowed a basis of $100 for the stock; that a taxpayer who exchanges a horse worth $100 for a cow worth $100 should be treated as if he had sold the horse for $100 and bought the cow for a like $100; and that a taxpayer who gives to a claimant in settlement of a disputed tort claim a share of stock worth $100 should be treated as if he had sold the stock for $100 and paid $100 in settlement of the claim.[16]

If that syllogism is good for the other cases, how can it not be good for *G*'s case? How is it rational to treat one as getting more out of an asset when he uses it to buy off a mortgage liability than if he used it instead to buy another asset, to pay an employee a bonus, or to buy off a tort claim? If we treat all other in-kind transactions as we would an equivalent for-money version of the transaction, why should we not treat an asset-for-liability-relief exchange as we would its for-money equivalent? If it generally offends reason and equity to attach different tax consequences to economically equivalent transactions, why is it any less offensive to do so here? And why, in any case, should anyone – and in particular the government! – *want* to create such a discrepancy?

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[15] To cause the transactions to have the same effects also for the other parties (*M* and *P*), one would need only to add to the in-kind version the following stipulation: "*P* a week later buys up the mortgage from *M* for $80." So to observe, however, is only to show how irrelevant the difference is.

[16] See *United States v. Davis*, 370 U.S. 65 (1962).

There is, of course, no answer to those questions. The simple truth is that an in-kind exchange of an asset for relief from a mortgage liability is no different in any relevant aspect from any other kind of in-kind exchange and there is no reason whatever why its treatment should not be governed by the same principles.

2. *Express command of* § *1001(b)*. – A quite sufficient reason for using value as the measure of the receipt (and expenditure) to be taken into account is that, as was argued by the concurring opinion in the court below, (Pet. App. 38a), § 1001(b) of the Code says exactly that.[17] The contrary view offered in the majority opinion – that relief from a liability is a form of "money" rather than of "property" and therefore(!) need not be measured by its "value" (Pet. App. 35a, n. 9) – converts a purely formal distinction into one of inexplicable and bizarre content. A moment's reflection on the effect of § 1001(b) will reveal that the amount realized is measured by the "value" of what is received no less when what is received is money than when it is something else: it's just that "money" is itself the unit of measure; its nominal amount *is* its "value" (by definition); and it is accordingly both unnecessary and linguistically awkward to speak of its "value." The case, then, is that § 1001(b) includes in the amount realized the *value* of everything received that is either (1) obviously money (*i.e.*, U.S. currency) or (2) not money. Given that regime, is it coherent to characterize as "money" something received whose value is *not* determined by its face amount? And then construe § 1001(b) as requiring such curious "money" (*i.e.*, "money" not worth in U.S. dollars its recited "amount") to be taken into account, unlike every other kind of receipt to which § 1001(b) applies, at something other than its value? The answer is obvious: there is no basis whatever for assigning to § 1001(b) so bizarre a content.

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[17] § 1001(b): "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

The grounds on which the government attempts in this Court to reconcile its position with § 1001(b) are equally insubstantial. The first is a one-sentence *ipse dixit* that "The value of a release of a debt is necessarily equal to . . . the amount originally borrowed" by the obligor and not repaid (Pet. Br. 34, n. 27). The assertion – which among other things would mean that a release from a $100,000 tort judgment is a thing of no "value"! – is frivolous: whatever reason there may be for measuring the imputed receipt by the *basis* of the liability rather than by the *value* of the relief, it cannot be that the two attributes are one and the same![18] The second claim, even more stunning, is noted in the margin.[19]

Here too there is in the end a simple truth: § 1001(b) by its explicit terms requires the receipt to be measured by the *value* of what is received; so read, it makes perfect sense and conforms precisely to the fundamental principle that economically equivalent transactions should be treated alike; and read in any other way it makes no sense at all. It follows that, fairly read, § 1001(b) is by itself wholly dispositive of the issue.

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[18] If "value" as used in § 1001(b) has its conventional meaning – and the meaning the government itself would concede that it has with respect to all other kinds of receipts (*e.g.*, of a cow)! – what it denotes is simply the amount in money for which the item would be bought and sold in a transaction between willing parties.

In *G*'s case, we know from the stipulated facts that on the date of the transaction: $80 was the price at which the mortgage would have changed hands in a transaction between a willing buyer and a willing seller; $80 was what one who owned the farm free and clear could have obtained on the issuance of a new mortgage identical to the outstanding one; $80 was the difference between the value of the farm free and clear and its value as encumbered by the mortgage; $80 was all that a nonidiosyncratic owner of the farm would have been willing to pay for a release of the farm from the mortgage; and $80 was the value of what *G* himself gave up in exchange for his relief from the liability (the excess of the $200 value of the farm over the $120 received in money). If that is not sufficient to establish that the relief from liability *G* received had a "fair market value" of $80 and *only* of $80, then the words have no meaning.

[19] The claim (at Pet. Br. 35) is that § 1001(b), in defining "The amount realized *from* the sale or other disposition of property," does not require that the receipts included in the "amount realized" be limited to receipts that came to the taxpayer "from" the sale or disposition of the property – *i.e.*, that were received in consequence of the disposition – but permits the inclusion of (some wholly undefined and open-ended category of) receipts that were *not* received in exchange for the property – *i.e.*, receipts that occurred at another time and in exchange for something else! What else the "from" in § 1001(b) is there for – if not to impose just such a crucially needed limitation – and how the provision as read by the government could be given a coherent content, are, I suggest, unanswerable mysteries.

3. *Implications of capital-gains provisions and of* § *108.* – The use of the values of the exchanged items (in *G*'s case, $80) as the measure of the receipt and expenditure to be imputed results in separating from each other the portions of the overall gain ($45) that were caused respectively:

> (1) by an increase in the value of the asset during the time it was owned ($15); and
>
> (2) by a decrease in the value of the liability during the time it was "owed" ($30).

It is asserted in turn that the distinctions drawn by the provisions of the Code granting special treatment to capital gains (§§ 1201 *et seq.*) and to liability gains (§ 108) cannot be understood otherwise than as distinctions according to the *source* of the gains. It is further asserted, on that premise, that a gain whose source is a decrease in the value of a liability:

> (1) cannot properly be held to qualify as a capital gain under §§ 1201 *et seq.*;[20] and
>
> (2) if the other requirements are met, cannot properly be denied eligibility for deferral under § 108.[21]

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[20] It is indisputable (and undisputed) that such a gain cannot independently qualify as a capital gain (*i.e.*, if separately realized). The view of the government, rather, is evidently that the source and character of the gain is not what matters: what matters is whether the gain is realized in a separate for-money transaction (in which case it's ordinary income) or in an in-kind transaction (in which case it may be a capital gain)!

[21] As that suggests, eligibility under § 108 is an independently important question and may often be the only one at issue: *e.g.*, where the gain would not in any event qualify as a capital gain – because, say, of depreciation recapture – but would qualify (if treated as a liability gain) for deferral under § 108. The government's rule thus has two distinct "bites": it will in some cases grant to taxpayers capital-gains treatment to which they would not otherwise have been entitled (*i.e.*, if the accrued liability gain had been realized in a separate transaction); and will in other cases deny to taxpayers the relief under § 108 to which they otherwise *would* have been entitled. Compare *Millar v. Commissioner*, 577 F.2d 212 (3d Cir. 1978) (capital gains treatment granted), with *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979) (§ 108 relief denied).

The final assertion is that, if the preceding assertions are sound – as of course they are – the use of the value of the exchanged items as the measure (so as to separate the gains from the two sources) is dictated as much by § 108 and §§ 1201 *et seq.* as it is by § 1001(b).

4. *Consistency in treatment of mortgagor and mortgagee.* – When a mortgaged asset is surrendered to the mortgagee, the mortgagee is treated as having received on the note a payment equal to the *value* of the asset and as having paid a like amount for the asset. Regs. § 1.166-6. Only if the receipt and expenditure of the *mortgagor* are likewise fixed by the value of the asset will the treatment of the two parties be consistent: otherwise the amount deemed *received* for the asset by the mortgagor would be different from that deemed *paid* by the mortgagee (and likewise as to the amount deemed received by the mortgagee and paid by the mortgagor for the discharge).[22]

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[22] The same point cannot be made, I acknowledge, with respect to a transfer to a third party (*e.g.*, as occurred in *G*'s case). The reason, however, is only that the treatment accorded by the Service to a taxpayer who issues a note (or otherwise accepts a liability) in exchange for an asset is itself subject to essentially the same criticism as is the Service position in this case: namely, for the Service's inexplicable failure (despite the contrary intimations of *Crane*) to measure the amount deemed received for accepting the liability and expended for the asset by the *values* of the items exchanged. That, however, is an even larger issue than the one in this case and obviously can't be explored here.

[Lest, however, the government make the contrary claim – *i.e.*, that its treatment of *G* is consistent with that of *P* while that urged here is not – I should note that the similarity of the Service's positions on the two issues is limited to the nature of the *errors* they reflect and does not extend to the *content* of the two rules. However similar the language the Service might use to state the two measures, it would in fact: (1) measure *G*'s receipt and expenditure by *G*'s *basis* for the liability ($110) and (2) measure *P*'s receipt and expenditure instead by the recited "principal" amount of the note ($100). And those two measures, as may be seen, are not at all the same.]

5. *Consistency with Crane.* – The use of value as the measure is required also, finally, by the decision in *Crane*. The Court's reasoning was essentially as follows:

> (1) The building had a market value equal at least to the "principal" balance of the mortgage ($255,000) plus the boot paid ($2,500), else the boot would not have been paid.[23]
>
> (2) Mrs. Crane could therefore have sold the building for cash in that amount and used the proceeds to pay off the mortgage. Had she done so, she would undeniably have received a "benefit" equal to the principal of the debt plus the boot (*i.e.*, equal to the money received).
>
> (3) The actual transaction was exactly equivalent in its effects to, and therefore necessarily produced for Mrs. Crane the same "benefit" she would have derived from, the supposed one. It follows that she must be deemed to have received for the building an amount equal to the principal of the debt plus the boot paid (*i.e.*, equal to what she could have sold the building for in a separate sale).

One need only eliminate from that argument what is unessential (the references to the "principal" of the debt combined with the inference that that amount was equal in turn to the value of the building) to see that the Court's true holding was that Mrs. Crane should be deemed to have received for the building an amount equal to its *value*, the amount for which it could have been sold in a separate money transaction. And that that is indeed what the

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[23] The Court's inferences about the market value of the building were in fact, of course, quite unsound: the mere *presence* of "boot" proves no such thing, and the negligible *amount* of the boot that was paid suggests just the opposite. The fallacy can be made obvious by asking this question: if the "equity" in the building was worth only $2500, how much was the *mortgage* worth? Is it likely that an investor in mortgages would have been willing to pay anything like $255,000 for the mortgage? And if the mortgage was worth much less than $255,000, and the "equity," only $2500, what does *that* tell us about the value of the building? All of that, however, goes only to the soundness of the Court's factual assumptions, and it impairs not at all the force of its rulings on the facts as it took them to be.

Court meant – though clear enough, one would think, from the opinion itself – is put beyond doubt by footnote 37.

6. *Conclusion*. – The use of the *values* of the exchanged items as the measure of the receipt and expenditure to be imputed in an asset-for-relief exchange is required, in sum: (1) by the explicit terms, and only coherent reading, of § 1001(b); (2) to give effect to the source distinction implicit in the capital-gains provisions of the Code (and in § 108 as well); (3) by the principle, essential to a rational tax system, that economically equivalent transactions should have like tax consequences; (4) to be consistent with the treatment of all other kinds of in-kind transactions; (5) to give consistent treatment to the two parties to the same transaction (in the case where the asset is surrendered to the mortgagee); and (6) by this Court's decision in *Crane*. The case for the use of that measure, in a word, is overwhelming.

C. THERE IS NO COHERENT RATIONALE FOR MEASURING THE DEEMED PAYMENTS BY THE BASIS OF THE LIABILITY AND DOING SO WOULD YIELD INDEFENSIBLE RESULTS.

The government's argument is that the deemed receipt should be in an amount equal to the taxpayer's *basis* for the liability.[24] Offered here are some further, somewhat more direct, criticisms of that argument.

1. *The false premise of the argument.* – The only reason the government offers for including the taxpayer's basis for the liability in the amount he is deemed to have received for the asset is the claim that, if it is not so included, the taxpayer's prior receipt for accepting the liability will not be accounted for at all. As it has been the purpose of this brief to demonstrate, that is not

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[24] The government, for want of a name for the crucial amount, refers to it in terms that range from the quite precise (the "unrepaid funds borrowed" by the taxpayer, Pet. Br. 13) through the ambiguous (the "amount of the unpaid debt," p. 20) to the wholly inappropriate (the "face amount of the mortgage," pp. 27, 37). It is clear from the full context in which the various phrases are used, however – and from the rationale of its argument – that what the government in fact means to denote is precisely the amount that has been defined here as the taxpayer's "basis" for the liability: to wit, the amount received by the taxpayer for accepting the liability and not yet accounted for.

what would "otherwise" occur. The real issue is only whether all of the gain should be treated as an asset gain or part of it as a liability gain, and on that issue the government has offered no argument at all.

2. *The illogic of the measure.* – To account for an exchange of an asset for relief from a liability, there are four items that must be determined: (1) the taxpayer's basis for the asset; (2) his basis for the liability; (3) the "amount received" by him in exchange for the asset; and (4) the "amount expended" by him in exchange for his relief from the liability. The two basis items are fixed by the taxpayer's *prior* receipts and expenditures with respect to the asset and the liability and the account previously taken of them for tax purposes. The "amount received" for the asset and the "amount expended" for the relief, in contrast, are the receipt and expenditure that occurred in the later transaction in which the asset was disposed of and the relief obtained. Inasmuch as the receipts and expenditures they reflect occurred at entirely different times and in different transactions, there is patently no causal or other relationship between either of the two basis items, on the one hand, and either of the two items of receipt and expenditure that occurred in the *later* exchange transaction, on the other. How then is it rational to select one of the former two items – specifically, the taxpayer's basis for the liability[25] – and make it the determinant of the amount of the latter two items (*i.e.*, the amount deemed received and expended in the later exchange transaction)?

The answer, obviously, is that there is no rational basis whatever for doing so. That the government makes no argument for its rule save the (false) claim of necessity is thus readily accounted for: there is no other argument that it *could* make.

3. *The impermissibility of the distinction drawn between recourse and nonrecourse liabilities.* – Although the government's brief is less than clear on the point, the regulations are explicit

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[25] The taxpayer's basis for the asset, it may be seen, has essentially the same relationship to the amounts to be determined as does his basis for the liability, and it would in fact therefore make fully as much sense to use his basis for the *asset* as the measure as it would to use his basis for the *liability*. Which is, of course, but another way of saying that neither measure makes any sense at all.

that their rules for asset-for-relief exchanges involving nonrecourse liabilities are quite different from the rules that are to be applied when the taxpayer is personally liable on the note. If the taxpayer is personally liable, the regulations prescribe, there is to be a separate reckoning for the gain or loss derived from the liability transaction as such, and for that purpose – *i.e.*, to separate the asset gain and the liability gain – the amount deemed received by the taxpayer for the asset and expended by him for the liability relief is to be fixed by the *value* of the exchanged items.[26] It is only when the liability is without recourse that there is to be no separate accounting for the liability gain; only then that the amount deemed received for the asset is to be fixed by the *basis* of the liability; and only then that the entire gain is to be treated as an asset gain.

The distinction thus drawn between recourse and nonrecourse liabilities is, quite simply, wholly inconsistent with the *Crane* doctrine and with the treatment of a nonrecourse liability in every *other* respect as being a "liability" of the asset's owner. See pp. 6–8, *supra*. It is also wholly irrational: there is simply no rational connection between (1) whether the taxpayer was or wasn't personally liable on the note and (2) whether the gain resulting from the decline in the value of the liability (in *G*'s case, the $30 gain) should or shouldn't be treated as an asset gain rather than as a liability gain.

4. *The indefensible effects of the rule.* – It will usually be simple enough for a taxpayer, if he wishes to, to avoid the application of the Service's rule: to do that, he needs at most only to separate his purchase of relief from the liability and his sale of the asset. The principal effect of the Service's rule, accordingly, is simply to give taxpayers a choice, in cases where it is possible for

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[26] See Regs., §§ 1.1001–2(b) and (c)(Ex. 8) and 1.1017–1(b)(5). The second of the cited regulations seems on its face to require that treatment equally in transactions involving nonrecourse liabilities, but the Service's litigating position was otherwise, and § 1.1001–2, adopted on December 11, 1980, now makes the distinction explicit.

them to bring their transactions within the scope of the Service's rule, whether:

> (1) to have their liability gains and losses (or accrued expenses) accounted for separately and according to their own characters; or
>
> (2) to have them bundled in with an asset gain or loss and be accounted for according to the character of the asset gain or loss with which they are bundled.

What the existence of that option would mean in practice, in turn, is a matter that depends on the ingenuity of tax lawyers. Even a neophyte at tax planning, however, can offer some suggestive examples of how the option might be employed, and that is what will be essayed here.

(a) *Liabilities with a basis in excess of value.* – In situations in which the taxpayer has a basis for his liability in excess of its value (*i.e.*, has an accrued liability *gain*), the planning challenge is whether the gain can be converted, via the Service's rule, into an asset gain (or reduction of loss) that would be more favorably treated. Given here are two examples that suggest some of the possibilities.

A's Case: A owns some railroad freight cars he acquired in an equipment-leasing venture and on which he has taken large depreciation deductions. The cars are pledged as security for a nonrecourse liability. *A*'s basis for the liability is \$100. The value of the cars, for which there is a ready market, is \$60, and *A*'s basis for the cars is also \$60. Fearful that the cars will decline in value even more, the noteholder, *N*, is threatening to foreclose. Were that to happen, *A* would under the Service's rule be deemed to have received \$100 (his basis for the liability) for the freight cars; and because of the "depreciation recapture" rules of § 1245, his resulting gain (\$40) would all be ordinary income.

To turn the Service's rule instead to his advantage,[27] *A* negotiates with *N* an agreement pursuant to which he buys government bonds with a value of $60 and pledges the bonds as substitute security for the note held by *N*. *N* in return releases his security interest in the freight cars and extends the due date of the note for a year and a day.[28] *A* immediately sells the cars for $60. A year and a day later, *A* surrenders the bonds to *N*. As a result of that transaction, *A* would under the Service's rule once again be deemed to have received $100 for the surrendered asset, but the asset deemed so sold would now be the government bonds rather than the freight cars, and the resulting $40 gain would as a consequence now be taxable as a capital gain rather than as ordinary income!

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[27] If *A* wanted merely to *escape* from the Service's rule, rather than take advantage of it, he could simply buy up the note for \$60 in cash and then immediately sell the cars for the same amount. That would cause his \$40 liability gain to be recognized as what it is – a *liability* gain – and thus make him eligible for the treatment afforded such gains by § 108.

B's Case: B owns an office building subject to a long-term mortgage for which *B* is also personally liable. *B*'s basis for the liability is $100, but because of a rise in interest rates since the note was issued, the bank holding the mortgage has offered to surrender it for $75. *B* also owns a home that he wishes to sell and that has a basis of $235 but a value of only $200. Wishing both to buy off the mortgage and to sell his home but to pay no taxes, *B* negotiates an agreement with the bank under which he gives the bank a mortgage on his *home* as security for his note and receives in return a release both of his personal liability and of the mortgage on his office building. A week later, *B* sells the house, subject to the mortgage, for $125.

In accounting for that transaction, *B* would under the Service's rule be deemed to have received for the house a total of $225 (the $125 he received in money plus his $100 basis for the liability) and thus to have sustained a loss on his sale of the house of only $10 rather than of $35 (his true loss). Losses from sales of personal residences are, of course, not deductible. By succeeding thus in converting his accrued liability gain into a reduction of his loss on the sale of his house, therefore, *B* would in fact have succeeded in wholly escaping tax on the gain.

(b) *Liabilities with no basis.* – Even more striking are the implications of the Service's rule as applied to liabilities for which the taxpayer has no basis at all – *e.g.*, liabilities for accrued expenses (interest, wages, rent, *etc.*.) that, under the taxpayer's method of accounting, have not yet been "recognized" and taken into account. The challenge here is use the Service's rule to convert such expense items into a reduction of an asset gain (or increase of an asset loss) that will receive more favorable treatment. Two examples suggesting how that might be done follow. The first is perhaps dramatic enough, but it is only the second that suggests the truly wonderful possibilities the Service's rule would open.

---

[28] Inasmuch as *N* would need an inducement to agree to the proposal, it might be more realistic to suppose that *A* "sweetens" the deal by pledging, say, an extra $2 worth of bonds. For simplicity, though, I've kept the numbers unchanged. The interest accruals during the year are being ignored for the same reason.

C's Case: C borrows $100 on a nonrecourse note secured by corporate stock. The note calls for a single payment at the end of six years of $190. *C* uses the $100 so borrowed to buy tax-exempt municipal bonds. One week before his note is due, with the stock then being worth $350, *C* sells the stock subject to the liability for $160. Under the Service's rule, *C* would be deemed to have received for the stock only $260 (the $160 received in cash plus only the *basis* of the liabilities, $100).[29] The effect, it may be seen, is to allow *C*'s taxable gain from the sale of the stock to be reduced by his $90 of accrued interest expense notwithstanding that no deduction would have been allowed for a direct payment of the interest (§ 265(2)).

D's Case: D, a painter of renown, negotiates a lease of an apartment under which he pledges one of his paintings as security for the rent to become due under the lease. The rent is not to become payable until the end of the term and the lessor's sole recourse, in the event of nonpayment, is to be by foreclosure on his security interest in the painting. At the end of the term, when $30,000 is due to the lessor, *D* sells the painting, subject to the pledge, for $20,000. The purchaser promptly pays the rent due to the lessor.

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[29] That the government recognizes that its rule requires accrued interest to be ignored is confirmed by its actions. That there must have existed accrued interest on the debt both in this case and in each of the other "footnote 37" cases that have been litigated (see Pet. Br. 35–40) is patent, yet in none of the cases has the government taken any note at all of the interest liability. Accrued interest is similarly ignored in § 1.1001–2 of the regulations. One would almost think that, rather than being present in virtually every case, accrued interest on a debt was something that didn't exist!

On his tax return, *D*, citing the Service's regulation, reports as his amount received from the sale of the painting, and hence as income, only the $20,000 in money he received. It is reported that *D* is now considering paying for the services of his maid and of his divorce lawyer in the same way.

CONCLUSION

On the narrow "Question Presented" on which certiorari was sought and granted, that also being the only issue that was presented to or decided by the court below, the decision of the court below is correct and should be affirmed. Whether the *judgment* of the court below should also be affirmed – or whether the tax deficiency should instead be sustained on the different ground on which it *should* have been determined – is a question on which the *amicus* has no special competence and takes no position.

Respectfully submitted.

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Amicus Brief

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THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

COMMISSIONER OF INTERNAL REVENUE,
Appellant

v.

JOHN F. TUFTS AND MARY C. TUFTS, ET AL.,
Appellees

BRIEF FOR AMICUS CURIAE

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF AMICUS CURIAE

This brief supports the position of the appellees.

I.

The question for review

The case presents a single issue — does the transferor of a property incumbered by a non recourse mortgage realize gain in the amount of the mortgage, *when the fair market value of the property is less than the amount of the mortgage.*

The answers to two underlying questions may influence the Court in the resolution of this issue.

The first is: if undeserved deductions are to be recovered on sale of property, is this to be accomplished by legislation or by litigation?

The second is: has Congress adopted a policy that controns this matter? There may be substantial opinion that depreciation deductions of that part of basis consisting of a non recourse mortgage should be recovered on a transfer of the property but there is also substantial doubt if this is consistent with Congressional policy.

II.

The Amicus Curiae

The Amicus Curiae is advised that Counsel for both parties, by letters to the Clerk of the Court, have consented to the filing of this brief.

1. Identification of Amicus Curiae.

Empire Real Estate Board, Incorporated, the amicus curiae, is an organization in Atlanta, Georgia of which all of the black realtors and affiliated persons are members, approximately 500 in all. Although all investors and developers have an interest in the case at bar, this association of minority persons has a special interest which it believes should be brought to the attention of the Court.

2. Interest of Amicus Curiae.

The interest of the Amicus Curiae is the same as that of the Appellees except that it is special and larger. It is described in this summary:

> A. A non recourse mortgage protects those who need protection.
>
> Investors in real estate or developers who cannot afford to finance a project that fails, seek protection by financing through a non recourse mortgage. When a project succeeds it is irrelevant to the investor whether it is funded by recourse or non recourse financing, but protection is needed if the project may fail. The need for protection of this kind has been recognized by the Department of Housing and Urban Development which by practice insures exclusively non recourse mortgages on housing projects. (F.H.A. form 2466) Protection against the possibility of failure is needed more often by minority investors than by large corporate promoters or syndications.
>
> B. Reversal of *Tufts* would deny needed protection.
>
> If *Tufts* should be reversed, this needed protection would be denied. A reversal of *Tufts* would mean that the penalty on developers of failed projects will be almost (one-half at 50% tax rate) as great as if the mortgage financing the project were with recourse. This would penalize more frequently minority investors.

C. The tax penalty would be retroactive.

The removal of this protection and the imposition of this penalty would be retroactive. Existing developers of projects that fail will be penalized.

D. Investors reasonably expected to have this protection.

This retroactivity will be imposed in spite of the reasonable expectations of those developers and investors who have relied on what seemed to be the law governing these transactions: i.e. the law as derived from the plain words of the Internal Revenue Code in Sections 1001 and 752 and the limitations stated by this Court in the *Crane* case.

E. A reversal will create harsh consequences.

A reversal of *Tufts* by this Court will create harsh consequences which could be mitigated by equitable considerations if the problems of the Internal Revenue Service were relieved through legislation rather than by litigation.

F. A reversal would nullify Section 465 of the Internal Revenue Code.

A reversal of *Tufts* would by indirection nullify the special exclusion of Section 465 of the Internal Revenue Code and would do so for some but not all investors. Minority investors are more likely to be in the unfavorably affected group.

G. The result sought by the Internal Revenue Service is unfair.

Section 465 prohibits tax deductions of amounts that are not at risk (including expressly non recourse mortgages). Because the housing industry is so important to the economy the section does not apply to it. (Section 465c(3)(D) The Internal Revenue Service asks the Court to take an unfair action. This appears from the consideration of just one scenario.

One investor in a housing project has black tenants who lose their employment in an economic recession. The non recourse mortgage goes into default and is foreclosed. The Internal Revenue Service wishes to treat the full amount of the mortgage as a taxable gain though the project is worth much less. The other investor has white tenants who remain employed and pay their rent. The mortgage does not go into default and is not foreclosed. Both investors take full advantage of depreciation deductions but the white investor does not transfer the project and is never considered to have a taxable gain. Is this fair? Could not a better solution be devised by Congress?

III.

Summary of Argument

In seeking judicial authority for frustrating what is asserted to be a tax shelter, the Internal Revenue Service asks this Court to: distort the plain meaning of Sections 752 and 1001 of the Internal Revenue Code, ignore the limitations this Court has placed on *Crane*, repeal Section 465c(3)(D) of the Internal Revenue Code, discriminate between investors similarly positioned, and disregard a stated Congressional policy. Our Courts should not act in this manner. However, these considerations do not handicap Congress. If there is a problem it should be resolved by legislation, not by litigation. Only legislation can deal fairly with investors.

IV.

The Argument

1. The argument for reasonable expectation.

Investors in real estate projects could reasonably expect that the Court of Appeals in the *Tufts* case, (*Tufts v. Commissioner,* 651 F.2d 1058 (5th 1981)) stated the law as it exists today.

A. The *Crane* case (*Crane v. Commissioner,* 331 U.S. 1, 1947).

This landmark case involved the sale of property whose fair market value was larger than the amount of the non recourse mortgage. In that it differs from the case at bar.

The Court in *Crane* followed the plain meaning of the language in the statute. The rationale of the decision is outlined as follows:

(1) Section 1001 of the Internal Revenue Code. Section 1001 of the Internal Revenue Code states that the "amount realized" on a sale is "the sum of the money received plus the fair market value of the property other than money received." The amount of a *recourse* mortgage is property "other than money." (Otherwise it would not be included in the amount realized.) Its "fair market value" is the amount of such mortgage.

(2) Where the property is worth *more* than the mortgage.

Where the value of the property subject to the mortgage exceeds the amount of the mortgage, the economic benefit derived from the release of such mortgage is substantially the same whether the mortgage is with recourse or is non recourse. The fair market value of the economic benefit is the same in both cases. The Court expressly recognizes this economic fact and states: "We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." (*Crane v. Commissioner*, 331 U.S. 1 at p. 14)

(3) Where the property is worth *less* than the mortgage.

The Court immediately recognized that this is not true where the property has a fair market value *less* than the amount of the mortgage. Footnote 37 is noted after the first sentence above quoted. Footnote 37 says "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." (*Crane v. Commissioner*, 331 U.S. 1 at pp. 14, 15) Could anything be clearer? Does it not create a "reasonable expectation"? The Court understands that any investor would regard the removal of a $5.00 lien on a $10.00 property as a benefit having a fair market value of exactly $5.00. This is the *Crane* case. Any investor who is not liable for payment of the lien would regard the removal of a $10.00 lien against a $5.00 property as being no benefit and as having no fair market value. This is the *Tufts* case.

B. Further consideration of Section 1001.

Section 1001 of the Internal Revenue Code embodies this principle. In determining gain, the "amount realized" is only "the money received plus the fair market value of the property (other than money) received." If no money is received and if no other property with market value is received, then no amount is realized and there is no gain. Does this not give a reasonable expectation?

C. Section 752 of the Internal Revenue Code.

Section 752 deals with the elimination of a non recourse mortgage on property held by a partnership. Any decrease of a partner's liabilities is treated as a distribution of money by the partnership. It then provides in 752(c): "For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered a liability of the owner of the property." (The Court of Appeals in the *Tufts* case in footnote 8 says that Section 752(c) is intended to be a codification of *Crane*.) Is it unreasonable to have an expectation from this Code Section?

D. The taxpayers in *Tufts* realized a loss.

The taxpayers in *Tufts* transferred their property without receiving consideration therefor. As a consequence these taxpayers sustained a loss in the amount of their investment, not a gain in the amount they had borrowed. There is no verbal magic by which this actual loss can be converted into a gain.

E. The Internal Revenue Service has not sought legislative change.

The Internal Revenue Service has contended that a taxpayer should not be permitted to depreciate that part of the basis of his property for which he has not paid and for which he is not liable for payment. Perhaps this is sound but Section 1012 defines the basis of property as cost and Section 167 permits depreciation of this basis. The Internal Revenue Service has tried to deal partially with this problem through Revenue Ruling 81-278 (Internal Revenue Bulletin 1981-48) and the decision of the Tax Court in *Bolger v. Commissioner*, 59 T.C. 760, 769 (1973). The ruling and the case provide that cost in excess of fair market value is not included in the basis of

> purchased property. However, a loss does not become a gain because of undeserved deductions in previous years — unless there is legislation which so provides. The Internal Revenue Service has not even asked Congress for help. Where was the Internal Revenue Service when Section 752(c) was adopted codifying *Crane* but refusing to enlarge the decision in *Crane*? Where was the Internal Revenue Service when Section 168 was enacted in 1981 creating the Accelerated Cost Recovery System? Where was the Internal Revenue Service when Section 465 was enacted and amended limiting deductions to amounts at risk but specially excluding real estate transactions? (Section 465c(3)(D)) Where was the Internal Revenue Service when Sections 1245 and 1250 were adopted providing for recapture of excessive depreciation? In fact, where has the Internal Revenue Service been in the thirty-five years since this Court wrote Footnote 37 in the *Crane* case and where is it now following the 1981 *Tufts* case and 2000 bills amending the Internal Revenue Code now awaiting passage by Congress. Statutes amending the Internal Revenue Code are adopted every year. The laws thus enacted in the last five years and the number of those awaiting action by Congress this year are listed in the Appendix. For some strange reason the Internal Revenue Service does not seek legislation. It asks the Courts not Congress to correct a situation that it has deplored for many years. (If Congress was asked and declined to help, then a fortiori the Court should not act.)

2. The Benefit Principal could be a part of the solution.

If there is a defect in the tax structure which should be corrected, it would not be inappropriate for the benefit principal to be a part of such correction. Section 111 of the Internal Revenue Code is the codification of this principle. That section provides that certain deductions are permitted if the prior deduction of the same items did not result in a tax benefit. It would not seem unfair to say that a real estate investor is to be taxed in a manner that recovers prior deductions but limits such taxation to the tax benefit previously enjoyed. Such a provision, of course, can be placed in our tax system only by legislation and not by the decision of the Court in this case.

3. Judicial corrective action is inappropriate.

If the present law contains an oversight or a defect or a structure that is unbalanced, judicial correction is inappropriate for the following reasons:

> It would be inconsistent with language of Sections 1001 and 752 of the Internal Revenue Code.
>
> It would be inconsistent with language of *Crane* and the rationale of *Crane*.
>
> It would be inconsistent with the true facts of the transaction. It would find a gain where, in fact, there is a loss.
>
> It would be inconsistent with Section 465 limiting deductions to amounts at risk except in the case of real estate and Sections 1245 and 1250 which provide for recapture of excessive depreciation.
>
> It could not provide for equitable considerations such as the benefit principal and retroactivity.

4. The Proper Solution is Legislative.

A. The deduction of costs that are not incurred.

> If it is wrong to depreciate costs that are not incurred, it would seem proper to bar such depreciation. This would shape the remedy to the malady and would apply to all investors, those who transferred and those who didn't transfer. If that is accomplished by legislation, the integrity of the judicial process would be protected and it would

be shown again that "the words of a statute — including revenue acts — should be interpreted where possible in ordinary, everyday senses". (*Crane v. Commissioner* 331 U.S. 1, 6). It is strange that the Internal Revenue Service has for thirty-five years refused to seek readily available legislative relief. The obscure reason for this reluctance may be a fear that Congress has a policy of favoring the home building industry. This fear has some foundation, in fact.

B. Section 465 states Congressional policy.

Section 465 bars the deduction of amounts not "at risk" in a number of named tax shelter projects and after 1978 in all trade and businesses. But Congress expressly provides in Section 465c(3)(D) that the Section does not apply to real estate activities. The construction of housing is encouraged in many other ways. For example, the several programs under the National Housing Act assist housing projects in many ways. The President has just vetoed an Act of Congress providing three billion dollars subsidies for housing. These circumstances give rise to the fear that Congressional policy would not permit the Internal Revenue Service to get what it wants.

C. Should the *Court* repeal Section 465c(3)(D)?

Those who think that the tax structure must be balanced by providing for recovery of unjustified deductions in prior years at the time of transfer of property, do not have the same concern for the protection of our judicial process. Analysis shows that reversal of *Tufts* would repeal Section 465c(3)(D) of the Internal Revenue Code (which unquestionably gives real estate projects favorable tax treatment). To tax depreciation deductions on the transfer of property is the exact equivalent of disallowing the deductions. Section 465c(3)(D) would thus be nullified. But it would be nullified in a manner haphazardly selective. If *Tufts* is reversed, the tax penalty would be applied only in foreclosures. No investor would voluntarily transfer property and thus bring on the tax penalty from which he is protected by Section 465c(3)(D).

V.

Conclusion

It is respectifully submitted that the decision of the Court of Appeals in the case at bar should be affirmed.

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APPENDIX

1977

P.L. 95-19, 91 Stat. 39 April 12, 1977
Emergency Unemployment Compensation Extension Act of 1977

P.L. 95-30, 91 Stat. 126 May 23, 1977
Tax Reduction and Simplification Act of 1977

P.L. 95-125, 91 Stat. 1104 October 7, 1977
Accounting and Auditing Act of 1950 Amendments

P.L. 95-147, 91 Stat. 1227 October 28, 1977
Secretary of the Treasury Authorization — Public Money Investments

P.L. 95-171, 91 Stat. 1353 November 12, 1977
Social Security Act — Extension

P.L. 95-172, 91 Stat. 1358 November 12, 1977
Tariff Schedules — Yarns of Silk

P.L. 95-176, 91 Stat. 1363 November 14, 1977
Internal Revenue Code — Distilled Spirits

P.L. 95-210, 91 Stat. 1485 December 13, 1977
Social Security Act — Rural Health Clinic Services

P.L. 95-216, 91 Stat. 1509 December 20, 1977
Social Security Amendments of 1977

1978

P.L. 95-277, 92 Stat. 11 February 10, 1978
Black Lung Benefits Revenue Act of 1977

P.L. 95-339, 92 Stat. 460 August 8, 1978
New York City Loan Guarantee Act

P.L. 95-345, 92 Stat. 481 August 15, 1978
Nonmember Telephone Companies Income

P.L. 95-423, 92 Stat. 935 October 6, 1978
Alcohol Tax Refund for Alcohol Beverage Losses

P.L. 95-427, 92 Stat. 996 October 7, 1978
Taxation of Fringe Benefits

P.L. 95-458, 92 Stat. 1255 October 14, 1978
Excise Tax on Trucks, Buses and Tractors

P.L. 95-472, 92 Stat. 1332 October 17, 1978
Tax Court Judges — Retired Pay

P.L. 95-473, 92 Stat. 1337, October 17, 1978
Revised Interstate Commerce Act

P.L. 95-488, 92 Stat. 1637 October 20, 1978
Black Lung Benefits

P.L. 95-502, 92 Stat. 1693 October 21, 1978
Bingo Games by Tax-Exempt Organizations

P.L. 95-599, 92 Stat. 2689 November 6, 1978
Surface Transportation Assistance Act of 1978; Title V, Highway Revenue Act of 1978

P.L.95-600, 92 Stat. 2763 November 6, 1978
Revenue Act of 1978

P.L. 95-615, 92 Stat. 3097 November 8, 1978
Tax Treatment Extension Act of 1977

P.L. 95-618, 92 Stat. 3174 November 9, 1978
Energy Tax Act of 1978

P.L. 95-628, 92 Stat. 3627 November 10, 1978
Revenue Laws — Timing Requirements

1979

P.L. 96-39, 93 Stat. 144 July 26, 1979
Trade Agreements Act of 1979

P.L. 96-72, 93 Stat. 503 September 29, 1979
Export Administration Act of 1979

P.L. 96-84, 93 Stat. 653 October 10, 1979
Unemployment Compensation Amendments of 1976

P.L. 96-167, 93 Stat. 1275 December 29, 1979
Fringe Benefit Regulations

P.L. 96-178, 93 Stat. 1295 January 2, 1980
State Legislators' Business Expenses

P.L. 96-187, 93 Stat. 1339 January 8, 1980
Federal Election Campaign Act Amendments of 1980

1980

P.L. 96-222, 94 Stat. 194 April 1, 1980
Technical Corrections Act

P.L. 96-223, 94 Stat. 229 April 2, 1980
Crude Oil Windfall Profit Tax Act of 1980

P.L. 96-249, 94 Stat. 357 May 26, 1980
Food Stamp Act Amendments of 1980

P.L. 96-265, 94 Stat. 441 June 9, 1980
Social Security Disability Amendments of 1980

P.L. 96-272, 94 Stat. 500 June 17, 1980
Adoption Assistance and Child Welfare Act of 1980

P.L. 96-283, 94 Stat. 553 June 28, 1980
Deep Seabed Hard Mineral Resources Act

P.L. 96-298, 94 Stat. 829 July 1, 1980
Airport and Airway Trust Fund — Extension of Taxes

P.L. 96-364, 94 Stat. 1208 September 26, 1980
Multiemployer Pension Plan Amendments Act of 1980

P.L. 96-417, 94 Stat. 1727 October 10, 1980
Customs Courts Act of 1980

P.L. 96-439, 94 Stat. 1878 October 13, 1980
Tax Court — Additional Judges

P.L. 96-451, 94 Stat. 1983 October 14, 1980
Recreational Boating Safety and Facilities Improvement Act of 1980

P.L. 96-454, 94 Stat. 2011 October 15, 1980
Household Goods Transportation Act of 1980

P.L. 96-471, 94 Stat. 2247 October 19, 1980
Installment Sales Revision Act of 1980

P.L. 96-499, 94 Stat. 2599 December 5, 1980
Omnibus Reconciliation Act of 1980

P.L. 96-510, 94 Stat. 2767 December 11, 1980
Comprehensive Environmental Responses Compensation and Liability Act of 1980

P.L. 96-541, 94 Stat. 3204 December 17, 1980
Temporary Tax Provisions — Extension

P.L. 96-589, 94 Stat. 3389 December 24, 1980
Bankruptcy Tax Act of 1980

P.L. 96-595, 94 Stat. 3464 December 24, 1980
United States Retirement Bonds — Interest Rates

P.L. 96-596, 94 Stat. 3469 December 24, 1980
Determination of Second Tier Taxes

P.L. 96-598, 94 Stat. 3485 December 24, 1980
Excise Tax Refunds for Certain Uses

P.L. 96-601, 94 Stat. 3495 December 24, 1980
Internal Revenue Code of 1954 — Simplification

P.L. 96-603, 94 Stat. 3503 December 28, 1980
Simplification of Private Foundation Return — Reporting Requirements

P.L. 96-605, 94 Stat. 3521 December 28, 1980
Miscellaneous Revenue Act of 1980

P.L. 96-608, 94 Stat. 3550 December 28, 1980
Taxation of Individuals Living Abroad

P.L. 96-611, 94 Stat. 3566 December 28, 1980
Parental Kidnaping Prevention Act of 1980

P.L. 96-613, 94 Stat. 3579 December 28, 1980
Miscellaneous Changes in Tax Laws

1981

P.L. 97-34, 95 Stat. 172 August 13, 1981
    Economic Recovery Tax Act of 1981

P.L. 97-35 95 Stat. 357 August 13, 1981
    Omnibus Budget Reconciliation Act

P.L. 97-51, 95 Stat. 958 October 1, 1981
    Appropriations — Fiscal Year 1982

P.L. 97-119, 95 Stat. 1635 December 29, 1981
    Black Lung Benefits Revenue Act of 1981

P.L. 97-123, 95 Stat. 1659 December 29, 1981
    Omnibus Reconciliation Act of 1981 — Social Security Act Benefits

1982 — Enactments through April 28, 1982

P.L. 97-164, 96 Stat. 25 April 2, 1982
    Federal Courts Improvement Act of 1982

There are approximately 2,000 bills now pending before Congress that relate to tax matters.

CERTIFICATE OF SERVICE

IN

THE SUPREME COURT OF THE UNITED STATES

NO. 81-1536

October term, 1981

Commissioner v. John C. Tufts and Mary A. Tufts, et al.

We hereby certify that three copies of the brief amicus curiae have been served on counsel for the Appellees by depositing same in the United States mail, properly addressed, with first class postage prepaid by Louis Regenstein, a member of the Bar of the Supreme Court and counsel for the Amicus Curiae. Service on the Appellant has been made on the counsel for the Appellant by personal service by Mr. William C. White, a member of the Bar of the Supreme Court, of the firm of Kilpatrick & Cody, by personally delivering three copies thereof to the Solicitor General of the United States.

In Witness Whereof, we have executed this Certificate of Service this 12th day of July, 1982.

LOUIS REGENSTEIN
Louis Regenstein

WILLIAM C. WHITE
William C. White

Docket Sheet

NO. 81-1536-CFX

TITLE Commissioner of Internal Revenue, Petitioner
v.
John F. Tufts, et al.

DOCKETED Feb. 16, 1982

COURT United States Court of Appeals for the Fifth Circuit

DATE	PROCEEDINGS AND ORDERS
	Counsel for Petitioner: Solicitor General
	Counsel for Respondents: Ronald M. Mankoff
Dec. 31, 1981	Application for an extension of time to file petition for writ of certiorari and order granting same until Feb. 16, 1982 by White, J., on Jan. 4, 1982.
Feb. 16, 1982	Petition for writ of certiorari filed. (Record filed).
Mar. 15, 1982	Order extending time by all respondents to file a response to the petition until Apr. 12, 1982.
Apr. 12, 1982	Brief for the respondents in opposition filed.
Apr. 14, 1982	DISTRIBUTED. 4-30.
May 3, 1982	Petition GRANTED.

June 15, 1982	Order extending time to file the joint appendix and petitioner's brief on the merits until July 17, 1982.
July 12, 1982	Brief, amicus curiae, of Empire Real Estate Board, Inc. filed.
July 15, 1982	Order further extending time to file the petitioner's brief on the merits until July 27, 1982.
July 27, 1982	Joint appendix filed.
Aug. 2, 1982	Brief for the petitioner filed.
Sept. 1, 1982	Order extending time to file the respondents' brief on the merits until Oct. 4, 1982.
Oct. 5, 1982	Brief for the respondents filed.
Oct. 5, 1982	Motion for leave to file brief as amicus curiae by Wayne G. Barnett filed.
Oct. 13, 1982	CIRCULATED.
Oct. 18, 1982	The motion of Wayne G. Barnett for leave to file a brief as amicus curiae is GRANTED.
Nov. 19, 1982	Reply brief for the petitioner filed. (D).
Nov. 29, 1982	ARGUED.